NATIONAL TAXPAYER ADVOCATE

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This report is dedicated to Bob Wenzel who, over the course of his forty year career with the IRS, most recently as Acting Commissioner, was able to successfully balance being a tax administrator par excellence and having compassion for the ordinary taxpayer.

PREFACE

Honorable Members of Congress,

It is my pleasure to submit to you for your review the National Taxpayer Advocate's 2003 Annual Report to Congress. Three themes are evident throughout this report. First, Congress and the IRS must act quickly and decisively to address several extremely serious problems confronting taxpayers. Second, IRS resources must be applied in a way that achieves a reasonable balance between enforcement activity, on the one hand, and customer service and taxpayer rights, on the other. Third, Congress and the IRS need to undertake more thorough research to ensure that legislative and administrative responses to perceived problems in tax administration are rooted in fact rather than impression or anecdote, and that initiatives actually achieve what they are designed to accomplish.

As required by statute, this report identifies and discusses 20 of the most serious problems encountered by taxpayers. The problem that I believe requires the most immediate and thorough response is the growing reach of the individual Alternative Minimum Tax. This problem is looming over all of us – taxpayers, Congress, the IRS. In the years to come, the IRS will be faced with applying resources to make adjustments to the returns of increasing numbers of taxpayers who were unaware that they, too, "won" the AMT lottery. For that is how the AMT appears to function – randomly, no longer with any logical basis in sound tax administration or any connection with its original purpose of taxing the very wealthy who escape taxation. Congress must address the AMT before it bogs down tax administration and increases taxpayers' cynicism to such a level that overall compliance declines.

The second most serious problem I identify is the government's failure to aggressively enforce the tax laws with respect to self-employed persons. Income earned by self-employed persons is not reported to the IRS on a Form W-2 and often is not reported at all. Thus, it is hardly surprising that self-employed persons account for the largest share of the known tax gap – the amount of improperly unpaid tax each year – which now is estimated at a whopping $310 billion annually. Why would the National Taxpayer Advocate highlight a problem that requires a response involving enforcement initiatives? The answer is simple – compliant taxpayers are impacted by the large tax gap attributable to sole proprietor taxpayers. Not only must compliant taxpayers pay more taxes in order to make up for a revenue collection shortfall, but their confidence in the system is shaken. How should a W-2 taxpayer, who has taxes taken out of her paycheck each week, feel when the free-lance carpenter making small improvements on her home brags about not reporting these private homeowner payments? Or her children's day care provider wants to be paid in cash?

To date, the IRS's response has been that these problems are intractable, that they require too much in the way of resources, and that it is busy pursuing high-dollar abusive tax schemes and low-dollar Earned Income Tax Credit noncompliance. But how can a fair and balanced tax system justify ignoring an issue that impacts many more taxpayers in their daily lives than either of those high profile compliance problems? If an effective response to the sole proprietorship tax gap requires additional resources, including more revenue agents and revenue officers in the field, then the IRS should make the case for those resources. It should not use the lack of resources as justification for a lack of response.

This report recommends that Congress implement a withholding mechanism on certain payments to self-employed persons to help address the problem. While this recommendation is sure to be controversial and the specifics can certainly be refined, I believe it represents a good starting point for discussions about the issue, and its primary virtue is that it sidesteps the age-old and intractable debate about which standards to apply in distinguishing between employees and independent contractors.

A second theme of this report is achieving the proper balance between (1) IRS enforcement activity and (2) customer service and taxpayer rights. Clearly, the IRS needs to maintain an active and vigorous presence in enforcing this country's tax laws. But these enforcement initiatives must be balanced with an equally vigorous protection of taxpayer rights, including the delivery of outstanding customer service. We need, somehow, to show taxpayers that their duty to comply with tax laws is balanced by the IRS's obligation to respect their rights – the right to disagree with proposed IRS adjustments and assert that disagreement within the tax system.

"Balance" figures prominently in our first legislative recommendation on confidentiality and disclosure of returns and return information. The promise that we will hold taxpayers' highly personal information in confidence forms the basis of all tax administration. Every proposal to create an exception to that promise must be balanced against the potential impact it will have on taxpayers' continued willingness to provide that information to the IRS. Because we can count on strong forces seeking access to that information – for example, the drive to increase government efficiency – I believe Congress must codify a balancing test to counter those forces.

The concept of balance also plays a role in the regulation of tax practitioners and preparers. While the IRS begins to look at high-end tax professionals – the lawyers and CPAs who traffic in corporate technical tax shelters or abuses of Roth IRAs – it cannot overlook the competency (or incompetency) of tax preparers who serve the majority of U.S. taxpayers.

For two years now I have called for action in regulating unenrolled return preparers. We have known about the problems associated with this population since before 1976, when Congress enacted preparer penalties and imposed basic requirements on return preparers. These problems have compounded with the advent of electronic filing and the entry of car dealers, pawnshops, and furniture stores into the tax preparation field.

In response to my proposal in last year's report for registration, testing, and certification of unenrolled return preparers, every major tax professional organization expressed support for some form of regulation, as did the Internal Revenue Service Advisory Committee (IRSAC), the Information Reporting Program Advisory Committee (IRPAC), and the Taxpayer Advocacy Panel (TAP). The IRS is the only major entity that does not support such a proposal, without any empirical evidence to justify its lack of action.

This leads to the third theme of the report – the need for better research on which to base and evaluate tax administration initiatives. Year after year, the IRS has failed to conduct even the most rudimentary research into understanding what is going on in the area of tax return preparation. In fact, it does not have a tracking mechanism for complaints about unenrolled preparers. The General Accounting Office's (GAO) recent report to Congress on this issue identified the impact on IRS resources as one consideration in going forward with a registration scheme. But GAO also noted that "data are lacking about the extent of problematic paid preparer behavior and the effectiveness of existing IRS actions, which makes it difficult to assess the tradeoff between benefits and costs."[1]

Thus, to get things rolling, I am proposing that Congress direct the Secretary of the Treasury to convene a joint task force to actually compile information about the extent of "problematic paid preparer behavior" and address all of the concerns raised by the IRS and others over the years about this issue. Lack of knowledge is no excuse for inaction; it merely calls for good research as a precedent to action.

In fact, the availability of good research is key to effective tax administration and achieving balance while taking action. For the IRS to act – in enforcement, in education, in allocating resources among programs – without a basis in research is to reduce tax administration to the level of gut instinct and reaction. Actions based on instinct alone can lead to violation of taxpayer rights and loss of confidence in the tax system.

[1] The disclosure provisions of the Victims of Terrorism Tax Relief Act of 2001 expired on December 31, 2003. At the time of printing this report, Congress has not yet acted on extension of the disclosure provisions.

Thus, throughout this report, we make recommendations for the IRS or for Congress to institute studies. These proposals are not meant to tie the hands of the IRS for years. Rather, they are intended to free the IRS to act wisely. This research can take several forms, discussed below.

Short-term, focused subject studies. An example of this type of research project involves Individual Taxpayer Identification Numbers (ITINs). The IRS, in the period of two months, conducted an in-depth study into the usage, distribution, and source of ITINs and the tax compliance rate of ITIN holders. The findings of this study were 180 degrees from earlier, superficial IRS analyses that had driven IRS policy for over a year and a half. The balanced policy changes adopted by the IRS in response to its new research findings (outlined in the most serious problem herein) clearly demonstrate the importance of good numbers to tax administration.

Pilot programs and proofs of concept. The IRS must use (and Congress should require) pilot programs in order to validate assumptions of effectiveness and impact and to test for unintended adverse consequences. The EITC certification/precertification pilot falls into this category. Further, I have proposed that pilot programs be required prior to any further legislative erosion of the confidentiality of taxpayer information under IRC § 6103. Where significant taxpayer rights are at stake, research in the form of pilots can serve as a sanity check so that full-scale action does not create problems for tax administration that will take years to reverse.

Long-term research as part of an action plan. Research initiatives such as the National Research Project (NRP) enable the IRS to identify areas of noncompliance so that it can better focus its compliance and education efforts. Further, the creation of a cognitive lab would enable the IRS to study what makes taxpayers behave the way they do. Why don't taxpayers respond to IRS letters? What is the best way to present information to taxpayers so they actually understand what is expected of them and so that we increase the odds that they will undertake the desired behavior? What is it about certain kinds of schemes that makes taxpayers override their risk aversion and make them willing to participate? This is information that a world-class tax agency should be exploring. Such information has significant practical application for tax administration.

Research as evaluation. As IRS launches new compliance or education initiatives, we need to know if they are, in fact, accomplishing what we hoped they would. When a new exception to confidentiality of return information is created, are we tracking the long-term consequences of that exception? Have advances in technology – information sharing – or in the private sector – commercial databases – eliminated another federal agency's need for IRS taxpayer information? Research as evaluation can be an important tool in reinforcing key values in the tax system and protecting them from unnecessary erosion. Program improvements and refinements, based on follow-up research, can ensure that IRS initiatives are narrowly tailored to achieve their purpose and do not have unintended and negative impact on tax compliance.

These are the themes of this report – action, balance, and research. Balanced, well-researched programs do not hamper IRS enforcement or other actions. In fact, they strengthen these actions and, more importantly, taxpayers' confidence in a fair and efficient tax system.

Respectfully Submitted,

Nina E. Olson
National Taxpayer Advocate
31 December 2003

PREFACE

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METHODOLOGY OF THE MOST SERIOUS PROBLEM LIST

Over the past year, we objectively evaluated and ranked each taxpayer problem according to the following factors:

- Impact on taxpayer rights
- Percentage of taxpayers affected
- Barriers to taxpayer compliance, including expense, time, and burden
- Impact of noncompliance on tax revenue
- Congressional interest
- National Taxpayer Advocate interest
- External stakeholders interest
- Frequency of issue in TAS case advocacy database

A detailed ranking of the 20 most serious problems appears in Appendix 5. Many of the issues impact both individual and business taxpayers; some apply to individuals exclusively while others affect only businesses.

TAMIS List

We have also prepared a second list of taxpayer problems based solely on Taxpayer Advocate Service (TAS) case inventories, as reflected by the Taxpayer Advocate Management Information System (TAMIS). This list, which appears as Appendix 1, details the 25 issues that generated the most contacts with TAS from October 1, 2002 through September 30, 2003. While some of the same topics appear on both lists of taxpayer concerns, the tracking codes used in TAMIS can encompass a variety of issues and may not reveal the underlying causes of problems. Further, taxpayers who contact TAS are a small subset of taxpayers who encounter problems with the IRS

IRS Response

As we do every year, we shared our definition and analysis of each problem with the IRS Operating Division Commissioners to give them a chance to comment on the issues.[1] Their responses are published in full under the headings "IRS Comments" and "IRS Initiatives to Address the Problem." We have also listed the "IRS Responsible Official" for each problem, although we recognize that other officials or Operating Division Commissioners may be involved in these issues. The Taxpayer Advocate Service then comments upon the IRS response.

[1] IRC §7803(c)(2)(B)(ii)(IV).

Problem Rank	Problem Title	Individual Taxpayers	Business Taxpayers
1	Alternative Minimum Tax for Individuals	✓	
2	Nonfiling and Underreporting by Self-Employed Taxpayers	✓	✓
3	Earned Income Tax Credit (EITC) Compliance Strategy	✓	✓
4	Appeals Implementation of the Collection Due Process (CDP) Program	✓	✓
5	Individual Taxpayer Identification Number (ITIN) Program and Application Process	✓	
6	Combination Letter	✓	✓
7	Offers in Compromise	✓	✓
8	Math Error Authority	✓	✓
9	Navigating the IRS	✓	✓
10	No Response Audit Cases	✓	
11	Taxpayer Assistance Centers (TAC)	✓	✓
12	Earned Income Tax Credit Outreach & Education	✓	✓
13	Earned Income Tax Credit Nonfilers	✓	✓
14	Separating Joint Accounts of Spouses	✓	
15	Criminal Investigation Freezes	✓	✓
16	Appeals Inventory Delays	✓	✓
17	Federal Tax Deposit (FTD) Penalty		✓
18	Federal Payment Levy Program (FPLP)	✓	
19	Manual Refund Inconsistencies	✓	
20	Combined Annual Wage Reporting (CAWR) Reconciliation	✓	✓

PROBLEM

TOPIC #1 **MOST SERIOUS PROBLEM: ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS**

DID YOU KNOW?

- The minimum tax was enacted into law in 1969 after Congress learned that 155 taxpayers with adjusted gross incomes (AGI) of $200,000 or more for the 1966 tax year had paid no federal income tax at all.[1]
- The Joint Committee on Taxation projects that within the next decade, almost two million taxpayers with incomes as low as $30,000 will have to prepare the AMT schedule with their tax returns - if only to prove that they do not owe AMT.[2]
- In tax year 2001, over 660,000 taxpayers with adjusted gross incomes under $200,000 paid more than $1.625 billion in AMT. The number of taxpayers with AGI of less than $50,000 owing AMT in 2001 is virtually the same as the number of taxpayers with AGI between $475,000 and $500,000 who owed no AMT.[3]
- By 2008, it will cost less to repeal the regular income tax structure and keep the AMT ($74 billion) than to abolish the AMT ($85 billion).[4]
- In 2005, it is projected that 65 percent of married couples with an adjusted growth income (AGI) between $75,000 and $100,000 with two or more children will be affected by the AMT - up from one percent in 2003.[5] Overall, the AMT is projected to affect approximately 12.7 million taxpayers in 2005 - up from just over 2.4 million today.[6]
- In 2010, the AMT is projected to affect nearly 32 million taxpayers.[7] The majority will have incomes under $100,000, and more than 36 percent of taxpayers with incomes between $50,000 and $75,000 will owe AMT.[8]
- Taxpayers must often fill out a 12-line worksheet, read eight pages of instructions, and complete a 65-line form – only to find they owe little or no AMT after all.[9] Other taxpayers must complete the 65-line form, even though they are not subject to the AMT, to substantiate their entitlement to certain tax credits.
- Taxpayers subject to the AMT must calculate their tax liability twice, once under regular income tax rules and again under AMT rules.

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1 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).

2 Joint Committee on Taxation data (as cited by American Institute of Certified Public Accountants, *AICPA Outline of Individual AMT*, Tax Analysts, 2001 TNT 131-77, April 23, 2001).

3 Tax Year 2001,Compliance Research Information System (CRIS), Model IFM 2003. Approximately 40,000 taxpayers fell into each category.

4 Leonard E. Burman, William G. Gale & Jeffrey Rohaly, Urban-Brookings Tax Policy Center, *The AMT: Projections and Problems*, Tax Notes, July 7, 2003, p. 109.

5 Id.

6 Joint Committee on Taxation (unpublished data furnished on Nov. 5, 2003).

7 Id.

8 Leonard E. Burman, William G. Gale & Jeffrey Rohaly, Urban-Brookings Tax Policy Center, *The AMT: Projections and Problems*, Tax Notes, July 7, 2003, pp. 105 and 107 (table 1).

9 2003 Form 1040 Instructions, Worksheet To See if You Should Fill in Form 6251, line 42, p. 38; Form 6251, Alternative Minimum Tax - Individuals.

- Taxpayers are projected to lose the benefit of nearly 12 billion dollars in tax credits (such as business credits) in 2010 because of AMT.[10]

DEFINITION OF PROBLEM

The concept of an add-on minimum tax entered the Internal Revenue Code more than three decades ago. Congress enacted the tax after hearing testimony that 155 taxpayers with adjusted gross incomes (AGI) above $200,000 had paid no federal income tax for the 1966 tax year.[11] The purpose of this add-on tax was to prevent wealthy taxpayers from escaping tax liability through the use of tax avoidance transactions.

Over time, however, the add-on tax - since modified and designated the Alternative Minimum Tax or "AMT" - has reached a very different taxpayer population than Congress originally intended. The AMT now impacts approximately 2.4 million taxpayers and is projected to affect nearly 32 million taxpayers by 2010, including many with incomes below $50,000.[12]

Far from affecting only the wealthiest taxpayers, the AMT by 2010 will raise 52 percent of its revenue from households with incomes of less than $100,000, up from nine percent today.[13] The AMT also imposes tax on many activities that can hardly be viewed as attempts at tax avoidance, such as having children (the tax benefits of dependency exemptions are lost under the AMT).

The mechanics and computation of AMT tax liability are so complex that many taxpayers may not even realize they are subject to the tax. Some taxpayers are dismayed to discover they have large AMT liabilities they did not anticipate and cannot pay. To make matters worse, the difficulty of projecting AMT tax liability in advance makes it challenging for taxpayers to compute and make required estimated tax payments, which often results in these taxpayers being subject to penalties.

Although there are no studies specifically measuring the compliance costs arising from AMT, the IRS has estimated that taxpayers spent over 29 million hours in 2000 completing and filing AMT tax forms, or roughly 63 hours per each taxpayer who actually pays the AMT.[14] This burden is growing dramatically as increasing numbers of taxpayers fall under the AMT regime.

[10] Department of the Treasury, Office of Tax Analysis, Paper 87, table 1 at p. 19, June 2000; IRC § 55(c)(2).

[11] 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).

[12] Joint Committee on Taxation (unpublished data furnished on Nov. 5, 2003); see also Leonard E. Burman, William G. Gale & Jeffrey Rohaly, Urban-Brookings Tax Policy Center, *The AMT: Projections and Problems*, Tax Notes, July 7, 2003, p. 107 (projecting that the AMT will affect 33.1 million taxpayers in 2010).

[13] Leonard E. Burman, William G. Gale & Jeffrey Rohaly, Urban-Brookings Tax Policy Center, *The AMT: Projections and Problems*, Tax Notes, July 7, 2003, p. 105.

[14] Internal Revenue Service, *Annual Report from the Commissioner of the Internal Revenue on Tax Law Complexity*, June 5, 2000, p. 26.

ANALYSIS OF PROBLEM

Background of the AMT

The concept of a minimum tax was initially developed in response to reports that a small, wealthy group of taxpayers was avoiding taxes altogether through the use of tax avoidance techniques.[15] In 1969, the House of Representatives adopted recommendations of the Treasury Department and passed a bill to impose a minimum tax by limiting certain tax preference items, in the aggregate, to 50 percent of gross income.[16] This approach required the use of a complex formula designed to allocate itemized deductions between taxable income and non-taxable income and to disallow those deductions allocated to non-taxable income.[17]

The Senate changed the bill, adopting instead a tax on specified preference items in excess of a $30,000 exemption amount.[18] The final bill followed the Senate's approach and imposed an add-on tax of 10 percent on nine specific tax preference items when the sum of the preference items exceeded $30,000.[19]

The Tax Reform Act of 1976 and the Revenue Act of 1978 both made modifications to the add-on tax. The 1976 Act, among other things, increased the add-on tax rate to 15 percent and lowered the exemption amount from $30,000 to $10,000.[20] The 1978 Act went a step further, restructuring the tax into two components. The add-on tax was retained for all tax preferences except the capital gains deduction and excess itemized deductions, and a new alternative minimum tax was established to adjust the taxpayer's income for these two items of tax preference. This new alternative minimum tax (AMT) imposed a progressive three-tiered rate structure on AMT: 10 percent on AMT income between $20,001 and $60,000; 20 percent on AMT income between $60,001 and $100,000; and 25 percent on AMT income over $100,000.[21]

In 1982, Congress repealed the add-on tax and replaced it with the alternative minimum tax (AMT).[22] Although Congress has enacted many technical changes over the past two decades, the basic structure of the AMT rules has remained intact.

[15] 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); Committee on Ways and Means of the U.S. House of Representatives and Committee on Finance of the U.S. Senate, 91st Cong., Tax Reform Studies and Proposals, U.S. Treasury Department, pt. 1, p. 132 (Comm. Print 1969).

[16] H.R. 13270, § 301(a) (version passed by the House of Representatives on Aug. 8, 1969).

[17] *See* H.R. Conf. Rep. No. 91-782, p. 301 (1969).

[18] H.R. 13270 (substituted version passed by the Senate on Dec. 11, 1969).

[19] Tax Reform Act, Pub. L. No. 91-172, § 301 (1969). The nine specified tax preference items were (1) excess investment interest income, (2) accelerated depreciation on personal property, (3) accelerated depreciation on real property, (4) amortization of certified pollution control facilities, (5) amortization of railroad rolling stock, (6) tax benefits from stock options, (7) bad debt deductions of financial institutions, (8) depletion, and (9) the deduction for capital gains.

[20] Tax Reform Act, Pub. L. No. 94-455, § 301 (1976).

[21] Revenue Act, Pub. L. No. 95-600, § 421 (1978).

[22] Tax Equity and Fiscal Responsibility Act, Pub. L. No. 97-248, § 402(a) (1982).

How the AMT Is Computed

The AMT is a separate system from the regular income tax, with unique rules governing the recognition of income and the timing of deductions and credits. Taxpayers are often required to maintain two sets of records - one for regular income tax purposes and one for AMT purposes.

The determination of AMT liability, if any, is complex:

- First, the taxpayer must calculate his or her 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.
- Second, the taxpayer must determine whether he or she is subject to additional tax under the AMT regime. The IRS has developed a 12-line worksheet (Worksheet To See if You Should Fill in Form 6251)[23] 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 contains 65 lines. Many taxpayers are required to complete Form 6251 - only to find that they do not have an AMT liability.
- Third, the taxpayer must compute their alternative minimum taxable income (AMTI) on Form 6251. This computation generally requires taxpayers to give up the benefit of tax preference items to which they are entitled under the regular tax system (e.g., dependency exemptions, a standard deduction, and itemized deductions for state and local taxes, employee business expenses and legal fees).[24]
- Fourth, the taxpayer must determine an "exemption amount" to which he is entitled based on filing status.
- Fifth, the taxpayer must compute his "taxable excess" by subtracting his exemption amount from his AMTI.
- Sixth, 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 26 percent rate and any additional "taxable excess" is taxed at a 28 percent rate. (The total amount is the tentative minimum tax).[25]
- Seventh, 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,

[23] 2003 Form 1040 Instructions, p. 38.

[24] 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.

[25] IRC § 55(b)(1)(A).

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.

- Eighth, if the taxpayer owes AMT, he computes his final tax liability by adding his regular tax liability and his AMT liability.[26]

The "exemption amount" described above replaces the standard deduction and personal exemptions for purposes of computing the AMT.[27] Prior to 2001, the AMT exemption amounts were $45,000 for married taxpayers[28] and $33,750 for most other taxpayers. Congress increased the exemption amounts in 2001 and then again in 2003 to $58,000 for married individuals and $40,250 for most other taxpayers through 2004,[29] but these higher exemption amounts are set to expire and revert to pre-2001 levels in 2005. The exemption amount is phased out for married taxpayers with AMTI exceeding $150,000 and non-married taxpayers with AMTI exceeding $112,500.[30]

A taxpayer who is subject to the AMT accrues AMT credits.[31] However, these credits may be applied only to timing items – not to exclusion items. Timing items are those that are accounted for in different tax years in the regular tax and AMT systems. For example, the AMT in some instances requires taxpayers to depreciate property over a longer period of time. Exclusion items are adjustments and tax preference items that result in the permanent disallowance of certain tax benefits such as the standard deduction, personal exemptions and certain itemized deductions. In addition, AMT credits can only be used when the regular tax liability reduced by other nonrefundable credits exceeds the tentative minimum tax for the tax year.

To claim AMT credits, taxpayers must complete Form 8801 (Credit For Prior Year Minimum Tax - Individuals, Estates, and Trusts), which the IRS estimates will take more than five hours.[32]

[26] In most cases, the taxpayer's final tax liability is simply the greater of his regular tax liability or his tentative minimum tax liability. But because the Code requires adjustments for tax from Form 4972 (Tax on Lump Sum Distributions) and any foreign tax credit from Form 1040, the Seventh and Eighth steps are required to ensure that taxpayers with these tax items obtain the correct result.

[27] IRC §§ 55(d)(1) & 56(b)(1)(E).

[28] In cases where married persons file separate returns, each taxpayer is entitled to 50 percent of the exemption amount allowable to married taxpayers who file joint returns.

[29] Economic Growth and Tax Relief Reconciliation Act, Pub. L. No. 107-16, § 701 (2001); Jobs and Growth Tax Relief Reconciliation Act, Pub. L. No. 108-27, § 106(a) (2003).

[30] IRC § 55(d)(3).

[31] IRC § 53.

[32] IRS Form 8801, Credit for Prior Year Minimum Tax - Individuals, Estates, and Trusts.

Problems Arising From the AMT

Some of the most significant problems arising from AMT include the following:

- Impact on "Wrong" Taxpayers - The AMT no longer targets just wealthy taxpayers who are not paying regular income taxes, but encroaches upon other groups. The number of AMT filers is projected to grow to over 30 million by 2010.[33] By that time, the AMT will become the de facto tax system for households with incomes between $100,000 and $500,000, with 92 per cent of them facing the tax.[34]
- Lack of AMT Knowledge - Taxpayers often file their returns not knowing about AMT or expecting to be subject to it, but subsequently receive bills relating to the AMT that they are not prepared to pay. In fiscal year 2003, the IRS closed more than 19,000 examinations that were initiated because of suspected AMT liabilities. These examinations resulted in additional tax assessments of nearly $39 million - more than $2,000 per return.[35]
- Complexity - The individual AMT is completely separate from the regular income tax structure. Taxpayers may need to fill out a 12-line worksheet and then a 65-line form (IRS Form 6251, Alternative Minimum Tax - Individuals) just to determine whether they are subject to AMT. Other complexities of AMT include the re-computation of the foreign tax credit,[36] its effects on incentive stock options[37] and capital gains rates,[38] and the treatment of income of minor children (the so-called kiddie tax).[39]
- Failure to Index AMT Exemptions for Inflation - Regular income tax standard deductions, exemptions and filing thresholds are all adjusted for inflation. The AMT exemption amounts, however, have not been indexed for inflation. When Congress enacted the add-on tax in 1969, the exemption amount was $30,000. If that amount had been indexed, it would be worth nearly $150,000 today.[40] Instead, as discussed above, the AMT exemptions are scheduled to return to $45,000 for married taxpayers and $33,750 for most other taxpayers in 2005.[41] The

[33] Joint Committee on Taxation (unpublished data furnished on Nov. 5, 2003); see also Leonard E. Burman, William G. Gale & Jeffrey Rohaly, Urban-Brookings Tax Policy Center, *The AMT: Projections and Problems*, Tax Notes, July 7, 2003, p. 107 (projecting that the AMT will affect 33.1 million taxpayers in 2010).

[34] Leonard E. Burman, William G. Gale Jeffrey Rohaly, Urban-Brookings Tax Policy Center, *The AMT: Projections and Problems,* Tax Notes, July 7, 2003, p. 105-106.

[35] IRS Wage & Investment Operating Division, Audit Information Management System (FY 2003 data).

[36] IRC § 59(a).

[37] IRC § 56(b)(3).

[38] IRC § 55(b)(3).

[39] IRC § 59(j).

[40] Department of Labor, Bureau of Labor Statistics, Consumer Price Index - All Urban Consumers (CPI-U) (Sept. 16, 2003).

[41] Economic Growth and Tax Relief Reconciliation Act, Pub. L. No. 107-16, § 701 (2001); Jobs and Growth Tax Relief Reconciliation Act, Pub. L. No. 108-27, § 106(a) (2003).

absence of an AMT indexing provision is largely responsible for the increasing numbers of middle-class taxpayers who are subject to the AMT regime.[42]

- Adverse Impact on Families - Married taxpayers will be more than 20 times as likely as single taxpayers to pay AMT in tax year 2010. Approximately 5.7 million taxpayers can be expected to pay AMT in 2010 simply because they lose the benefit of dependency exemptions under the AMT.[43]
- Loss of Itemized Deductions - An individual taxpayer must add back certain itemized deductions when computing AMT.[44] This causes difficulties for those with large expenditures such as legal fees in court settlements, state and local taxes, or employee business expenses.
- Unpredictability of Estimated Tax Payments - Because the law is so complicated, it is difficult if not impossible to predict whether an individual will be subject to AMT. This causes problems in paying the correct estimated tax for the year and can result in penalties for underpayment. In tax year 2001, over 176,000 taxpayers facing AMT were also required to pay nearly $103 million in estimated tax penalties.[45]
- Taxation of Incentive Stock Options - A taxpayer's exercise of incentive stock options creates paper (phantom) gain in the year the stock is purchased (the option exercise). This gain is not taxed under the regular tax rules but is taxed for AMT purposes. The gain is the difference between the option price and the market value of the stock on the date the option is exercised to purchase the shares.
- Two Computations of Foreign Tax Credits - Taxpayers who claim the foreign tax credit (and thus must complete the complex Form 1116 (Foreign Tax Credit)) are required to recompute the amount of the foreign tax credit if they are subject to the AMT pursuant to special rules in Internal Revenue Code section 59(a).
- Limitation on Availability of General Business Credits - General business tax credits are not denied for purposes of computing AMTI but are limited by the taxpayer's tentative minimum tax.[46] To illustrate, assume a taxpayer has a regular tax liability of $10,000 prior to credits, tentative minimum tax of $9,000, and a $2,000 credit under IRC § 44 for constructing an access ramp to his business for disabled

[42] The effect of the absence of AMT-exemption indexing is compounded by the fact that key tax preference items that are included in AMTI - e.g., the standard deduction and personal exemptions - are indexed annually.

[43] Leonard E. Burman, William G. Gale & Jeffery Rohaly, Urban-Brookings Tax Policy Center, *The AMT: Projections and Problems*, Tax Notes, July 7, 2003, p. 105-106.

[44] IRC § 56(b) & (e). Common itemized deductions that must be added back to income include, but are not limited to, state and local taxes, real estate and personal property taxes, mortgage interest not used for the purchase or improvement of a personal residence, medical expenses exceeding 7.5 percent but less than 10 percent of adjusted gross income, and certain miscellaneous itemized deductions such as employee business expenses and legal fees.

[45] Tax Year 2001, Compliance Research Information System (CRIS), Model IFM 2003.

[46] IRC § 38(c)(1).

individuals. Absent the credit, the AMT would have no effect on this taxpayer because his regular tax liability exceeds his tentative minimum tax. However, the disabled access credit would reduce the taxpayer's regular tax liability to $8,000, which is below his tentative minimum tax. Therefore, the taxpayer is only entitled to a credit amount of $1,000 and must carry back or carry forward the $1,000 credit balance. Under these circumstances, the taxpayer would be required to complete Form 6251 and attach it to his return - even though the taxpayer does not have an AMT liability - to substantiate his entitlement to a portion of the credit. In all, taxpayers are projected to lose nearly 12 billion dollars in tax credits, mostly business credits, in 2010 because of the AMT.[47]

- Timing Issues Resulting from AMT Tax Credit Regime - The portion of AMT attributable to timing items reflects the difference between when certain deductions are allowable under the AMT and when the same deductions are allowable under the regular income tax. The taxpayer can only claim an AMT credit in subsequent years when the regular tax exceeds the AMT.
- Requirement of Two Sets of Records - Taxpayers often must keep separate records for regular tax and AMT purposes. For example, assume a taxpayer placed an office building into service prior to 1999 and is claiming straight-line depreciation on the building. The taxpayer would depreciate the building over a 39-year period for regular tax purposes,[48] but for AMT purposes the depreciation period would be 40 years instead.[49]
- Inconsistent Treatment of Carryover Items - When a taxpayer loses a tax benefit because of the AMT, the taxpayer may or may not be entitled to carry the benefit to another tax year, and the carryover periods vary from item to item. For example, an unused credit otherwise allowable for placing a qualified electric vehicle into service may not be carried over.[50] If the credit cannot be used in the year in which the vehicle is placed into service, it is permanently lost. Unused general business credits, on the other hand, generally may be carried back one year and carried forward 20 years.[51] Unused foreign tax credits generally may be carried back two years and forward five years.[52]
- Two Computations of Capital Gains Tax - Capital gains are taxed for regular tax purposes at lower rates than the AMT rates. Because Congress wanted to preserve tax-favored capital gains treatment under the AMT regime, a taxpayer with capital gains who owes AMT must complete 30 lines on Form 6251 after having already

[47] Department of the Treasury, Office of Tax Analysis, Paper 87, table 1 at p. 19, June 2000; IRC § 55(c)(2).

[48] IRC § 168(c).

[49] IRC § 56(a)(1)(A)(i) (referencing IRC § 168(g)).

[50] A credit may be carried to another taxable year only if the Code expressly provides for it. In the case of the credit for placing a qualified electric vehicle into service, carryovers are not authorized. See IRC § 30(a).

[51] IRC § 39(a).

[52] IRC § 904(c).

completed the 53-line Schedule D (Capital Gains and Losses) for regular tax purposes.

- Increased Use of Paid Preparers - Approximately 55 percent of taxpayers without AMT liabilities pay to have their returns prepared. Where a taxpayer has an AMT liability, the use of paid preparers jumps to nearly 80 percent.[53]
- High AMT Marginal Tax Rates Due to Phase-out of AMT Exemption - As described above, the AMT rules impose tax at a rate of 26 percent on a "taxable excess" (i.e., AMTI reduced by the applicable AMT exemption amount) up to $175,000 and 28 percent on higher amounts. However, the AMT exemptions phase out at a 25 percent rate for married taxpayers with AMTI exceeding $150,000 and non-married taxpayers with AMTI exceeding $112,500.[54] Therefore, the AMT marginal tax rate can reach 35 percent.

Impact of the AMT

From October 2002 through August 21, 2003, the Taxpayer Advocate Service accepted more than 500 hardship cases directly related to difficulties taxpayers faced because of the AMT.[55] Many of these taxpayers did not understand that they were subject to AMT. A sample of 100 of these hardship cases found more than half were the result of IRS examinations, while many others were caused by math errors.[56] Other factors that produced AMT hardship cases were incorrect computations by the taxpayer or the IRS, taxpayers not being aware of the AMT, the impact of legal fees from employment-related settlements, the number of dependency exemptions claimed, filing status, foreign income, and credits for prior years. The following examples and tables highlight some of the AMT problems and inequities encountered by taxpayers.[57]

Example 1: AMT and Filing Status

In 2002, a married man with three children earned $20,000, received a lump sum settlement of $50,000 from a job-related injury, and incurred legal fees (i.e., attorney fees plus related legal costs) from the settlement of $25,000. If the taxpayer lived in New York, he would report 100 percent of the settlement income and deduct the $25,000 in legal fees on Schedule A (miscellaneous itemized deductions). The AMT would be $1,346. If the

[53] Tax Year 2001, Compliance Research Information System (CRIS), Model IFM 2003.

[54] IRC § 55(d)(3).

[55] Taxpayer Advocate Management Information System (TAMIS) query on Alternative Minimum Tax, Form 6251 (Oct. 1, 2002 to Aug. 21, 2003).

[56] Taxpayer Advocate Management Information System (TAMIS) query on Alternative Minimum Tax, Form 6251. Of the 100 cases sampled, 40 were due to IRS errors and 40 were due to taxpayer or preparer errors. Seventeen taxpayers did not know they were subject to AMT. AMT was attributable to exemptions or filing status in 15 cases, Schedule D or capital gains transactions in 14 cases, employee business expenses and other miscellaneous deductions in 10 cases, and foreign tax credits and legal fees for settlements in 5 cases each.

[57] For simplicity, the following examples do not take into account the effects of the child tax credit for purposes of computing the "Total Tax" rows. Examples 1 and 2 illustrate common AMT issues but are not drawn from specific TAS cases. Example 3 describes the facts of a TAS case.

husband decided to file a separate return, he would be required to file using married-filing-separate status and would face an AMT of $5,637. If the husband were not married and had custody of his three children, he would file as head-of-household and be liable for $4,241 in AMT.

The following table compares the AMT effects on the Married Filing Joint, Married Filing Separate and Head of Household filing status using 2002 tax rates.

TABLE 1.1.1, AMT AND FILING STATUS

Filing Status	Married Filing Joint	Married Filing Separate	Head of Household
Adjusted Gross Income (AGI)	$70,000	$70,000	$70,000
Schedule A Miscellaneous – Legal Expenses	$25,000	$25,000	$25,000
Tentative Minimum Tax	$5,460	$11,830	$8,905
Regular Tax	$4,114	$6,193	$4,664
AMT	**$1,346**	**$5,637**	**$4,241**
Total Tax	**$5,460**	**$11,830**	**$8,905**

Although the AMT exemption amounts have temporarily increased for tax years after 2002, Schedule A itemized deductions continue to be a source of inconsistent treatment for middle income families. The type of Schedule A itemized deduction is a key factor in determining whether an AMT obligation is triggered, because the AMT does not treat itemized deductions uniformly. A married couple with three children living in a high tax area or incurring high employee business expenses is more likely to owe AMT than a similar family that had other itemized deductions, such as mortgage interest or charitable contributions, which are not taken into account for AMT purposes.

Example 2: AMT and Deductions

In 2002, a married couple with five children had combined wages of $75,000 and paid $10,000 in state and local taxes. This couple was subject to $756 in AMT. If the couple had incurred $10,000 in employee business expenses or job-related legal fees instead, the couple would have been subject to AMT of $531. However, if the $10,000 in itemized deductions were a combination of $5,000 of mortgage interest and $5,000 of taxes, the couple would not have paid any AMT. Therefore, even though the couple had the same total income and itemized deductions under the regular tax rules, the difference in treatment of taxes and deductions under the AMT would produce different AMT liabilities and, in the third case, a total tax liability that is $756 lower.

TABLE 1.1.2, AMT AND ITEMIZED DEDUCTIONS

	Tax Year 2002: High Tax	Tax Year 2002: High EBE or Legal Fees	Tax Year 2002: Tax and Mortgage Interest Split
Filing Status	MFJ	MFJ	MFJ
Adjusted Gross Income (AGI)	$75,000	$75,000	$75,000
S&L Taxes	$10,000		$5,000
Schedule A Miscellaneous		$10,000	
Mortgage Interest			$5,000
Tentative Minimum Tax	$6,760	$6,760	$5,460
Regular Tax	$6,004	$6,229	$6,004
AMT	**$756**	**$531**	**$0**
Total Tax	$6,760	$6,760	$6,004
Difference	0	0	($756)

Example 3: The AMT and Incentive Stock Options

A taxpayer who worked as a computer programmer was granted incentive stock options. The fair market value of the stock was much higher than the price of the option, so the taxpayer decided to exercise her options and purchase the stock. However, because the difference between the option price (purchase price) and the market value is added back to income in determining AMT, this decision created AMT of over $520,000 even though the taxpayer had merely purchased stock and had not yet sold it. The following year, the stock price dropped sharply and the taxpayer lost her job. She could not pay the AMT liability, so she filed an offer-in-compromise with the IRS seeking relief from the AMT. The IRS declined the offer because of the taxpayer's substantial investment holdings and because she was still young with significant potential future earnings.[58]

TAXPAYER ADVOCATE COMMENTS AND RECOMMENDATIONS

Prior Recommendations: Repeal of AMT

The National Taxpayer Advocate first recommended repeal of the AMT in the Annual Report to Congress for 2001.[59] *We reiterate this recommendation.*

The AMT is extremely and unnecessarily complex and results in inconsistent and unintended impact on taxpayers. A recent newspaper column provided a description of the AMT that, although sarcastic, is accurate in detail:

> Here's an idea: Let's devise a politically inept tax policy. We'll begin by eliminating tax breaks people have been accustomed to for decades, such as those for qualified retirement accounts, and state and local taxes. Next, we'll negate the child tax credit so that families with young children will be

[58] Taxpayer Advocate Management Information System (TAMIS) query on Incentive Stock Options and AMT (Oct. 1, 2002 to Sept. 12, 2003).

[59] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), p. 172-173.

> hit especially hard. Then, we won't adjust for inflation, so that our tax will affect more people each year as their incomes grow along with the economy and inflation. We'll tell people that they must calculate their taxes twice, using two different formulas - and finally we'll add insult to injury by requiring them to pay whichever amount is higher.[60]

For reasons discussed in this report and the reasons highlighted in this newspaper passage, the AMT is bad policy, and its repeal would simplify the Internal Revenue Code, provide more uniform treatment for all taxpayers, and eliminate the oddity of dual tax systems. AMT repeal would also allow the IRS to realign compliance resources to facilitate more efficient overall administration of the tax code.

Members of Congress have considered the repeal of the AMT for several years. In 1999, Congress voted to repeal the individual AMT, but the legislation was vetoed.[61] During the 108th Congress alone, approximately 15 bills to modify or repeal the AMT have been introduced.[62]

As the reach of the AMT has expanded to ensnare increasing numbers of taxpayers, support has grown for its outright repeal or major reform. The American Bar Association Section of Taxation, the American Institute of Certified Public Accountants Tax Division, and the Tax Executives Institute have jointly called for the repeal of the AMT.[63] In testimony before the House Committee on Ways and Means on April 8, 2003, the National Association of Enrolled Agents also advocated outright repeal or substantial restructuring of the AMT for individuals.[64] In the alternative, the Tax Division of the American Institute of Certified Public Accountants has advocated making state and local taxes fully deductible for AMT purposes.[65]

If the AMT were repealed, Congress would have to determine how to treat unused prior-year minimum tax credits. AMT repeal would eliminate the timing issues of using claimed credits against AMT tax paid in prior years. However, a transition rule would be needed to address the outstanding AMT credits that have not yet been used as of the repeal date.

We acknowledge that the repeal of the individual AMT would carry a huge price tag. The cost of repealing or significantly reforming the AMT continues to grow. According to one study, by tax year 2008 it would cost less to repeal the regular income tax structure and keep the AMT ($74 billion) than to abolish the AMT ($85 billion).[66]

[60] Kevin Adler & Annette F. Simon, *Not Rich? You'll Pay Anyway*, The Washington Post, Nov. 2, 2003, p. B1.

[61] Taxpayer Relief Act, H.R. 2488, 106th Cong. (1999).

[62] A search of the term "alternative minimum tax" in the Library of Congress's THOMAS online database turned up 45 bills in the 108th Congress. It appears that the principal purpose of approximately 15 bills was to modify or repeal the AMT. The balance of the bills had unrelated objectives and addressed the AMT only incidentally.

[63] American Bar Association Section of Taxation, American Institute of Certified Public Accountants Tax Division & Tax Executives Institute, Tax Simplification Recommendations (Feb. 25, 2000), reprinted at 2000 TNT 39-82.

[64] 2003 Tax Return Filing Season and the IRS Budget for Fiscal Year 2004: Hearing before the House Ways and Means Subcommittee on Oversight, 108th Cong. (2003) (statement of Claudia Hill on behalf of the National Association of Enrolled Agents).

[65] American Institute of Certified Public Accountants, Taxation Division, *Comments on H.R. 22, The Individual and Small Business Tax Simplification Act of 2003*, April 17, 2003, p. 2.

[66] Leonard E. Burman, William G. Gale & Jeffrey Rohaly, Urban-Brookings Tax Policy Center, *The AMT: Projections and Problems*, Tax Notes, July 7, 2003, p. 109.

Therefore, if Congress decides to repeal the AMT, it would have to compensate for the lost AMT taxes by raising revenue through the regular tax system or reducing spending. Notwithstanding that admittedly daunting challenge, we believe it would be fairer, more transparent, and less burdensome to fund the government through the regular tax system than through the AMT, whose effects bear scant resemblance to what Congress intended when it originally enacted a minimum tax regime.

The National Taxpayer Advocate recognizes that repealing the AMT will result in some taxpayers owing nominal or no tax.[67] It may be possible to revise the definition of tax preferences under the AMT to lessen its impact on middle income taxpayers while applying the AMT to those taxpayers who are the modern day analogue of the original zero-tax high income taxpayers of 1967. Identifying new tax preferences, better aligned to today's tax avoidance techniques, may prove fruitful.

Alternative Recommendations to Limit the Impact of the AMT

If Congress determines that full repeal of the individual AMT is not viable at this time, we suggest that Congress consider revising the rules to align AMT more closely with its original purpose and application and take steps to reduce the complexity and burden the AMT imposes on taxpayers. The National Taxpayer Advocate recommends that Congress make at least one of the following changes to the individual AMT.

1. Establish a Gross Income Threshold for AMT

Establishing a return-based gross income threshold according to filing status would promote simplification and greatly aid taxpayers in determining their exposure to AMT without requiring complicated and time-consuming calculations. For example, Congress could exempt married taxpayers with gross incomes under $150,000 and other taxpayers with gross incomes under $75,000 from the AMT. This concept is already incorporated into the corporate AMT regime. Corporations with annual gross receipts not exceeding $5 million generally are exempt from the corporate AMT.[68]

If gross income thresholds are established, taxpayers would be able to determine from their tax returns whether they are subject to the AMT. The thresholds should be adjusted annually for inflation. This would shift the AMT back onto higher income taxpayers not paying taxes, and away from low income and middle income taxpayers.

The use of adjusted gross income for the gross income threshold would be the simplest option for taxpayers to apply. The taxpayer could simply look at the AGI amount on his or her return and readily determine whether the AMT could apply. However, this approach would create a potential advantage for taxpayers who have tax preference items

[67] One study estimates that in 2003, 600 taxpayers with income over $1 million escaped federal taxation entirely and another 2,7000 high income taxpayers escaped taxation before the application of the AMT. Leonard E. Berman, William G. Gale, and Jeffrey Rohaly, *The AMT: Projections and Problems*, Tax Notes 105 (July 7, 2003).

[68] IRC § 55(e)(1)(B).

from business ventures, including depreciation deductions, mining exploration and development costs, certain long-term contracts, or gains from the exercise of incentive stock options.[69] These items are some of the tax deductions Congress sought to limit when it initially enacted the AMT.

According to tax year 2001 data, approximately 40 percent of all AMT taxpayers would have been eliminated from AMT liability using AGI thresholds of $150,000 for married and $75,000 for other taxpayers. These taxpayers paid roughly $840 million in AMT in 2001, representing about 13 percent of the total $6.4 billion AMT paid for that tax year. A significant number of taxpayers - nearly 640,000 - would be relieved from AMT by using such an AGI approach.[70]

2. Index Individual AMT Exemptions for Inflation

Indexing the AMT exemption amounts would prevent the AMT from affecting increasing numbers of taxpayers each year solely because of the effects of inflation. Congress established an exemption amount of $30,000 when it initially enacted a minimum tax in 1969. While the exemption amounts have been changed several times since then, they have not kept pace with inflation. As described above, the $30,000 exemption amount enacted in 1969 would be worth nearly $150,000 today if it had been indexed for inflation.[71]

Legislation introduced in the House of Representatives in the 108th Congress would increase the exemption amounts for individuals and repeal the phase-out of exemptions. Under this proposal, the incremental increase to the exemption amounts would be phased in over 10 years, and after 2012 the AMT would be repealed.[72]

A similar recommendation has been formulated by the Tax Policy Center, a joint project of the Brookings Institution and the Urban Institute.[73] Indexing AMT exemptions for inflation after 2002 would mirror the indexing of exemption thresholds in the regular tax system and reduce the number of projected AMT filers in 2010 by 70 percent (over 20 million taxpayers).

This would significantly benefit the middle class, as the number of AMT filers with AGI between $15,000 and $75,000 would fall by 90 percent and the number with AGI between $75,000 and $100,000 would drop by 84 percent.[74]

[69] IRC § 56(a)(1), (a)(2), (a)(3) & (b)(3).

[70] Tax Year 2001, Compliance Research Information System (CRIS), Model IFM 2003.

[71] Department of Labor, Bureau of Labor Statistics, Consumer Price Index - All Urban Consumers (CPI-U) (Sept. 16, 2003).

[72] Alternative Minimum Tax Repeal Act of 2003, H.R. 43, § 3.

[73] Leonard E. Burman, William G. Gale, Jeffrey Rohaly & Benjamin H. Harris, *The Individual AMT: Problems and Potential Solutions*, Sept. 2002, p. 37.

[74] Id.

3. Eliminate Personal Exemptions, the Standard Deduction, State and Local Taxes, and Miscellaneous Itemized Deductions as Adjustment Items for AMT

Middle class taxpayers are particularly susceptible to the AMT because some of the most common deductions – such as the personal exemption, the standard deduction, and itemized deductions like state and local taxes and attorney fees – are added back to income for AMT purposes.

Studies indicate that by 2007, nearly 95 percent of AMT revenues will be attributable to four specific adjustments – the personal exemption, the standard deduction, state and local taxes, and miscellaneous itemized deductions.[75] This equates to nearly $53 billion in AMT revenue in 2007.[76]

The National Taxpayer Advocate recommends that Congress consider eliminating these deductions as add-backs in the AMT computation as a means of removing from the rolls of AMT filers substantial numbers of taxpayers against whom Congress never intended to impose AMT in the first place. This recommendation would reduce or eliminate the AMT burden for many taxpayers with large families, many taxpayers who live in areas with high state and local taxes, and many taxpayers who incur high miscellaneous itemized deductions.

For tax year 2001, this recommendation would have benefited 3.4 million taxpayers reporting state and local taxes and 1.2 million taxpayers reporting miscellaneous itemized deductions as part of their AMT calculations. The amount of AMT adjustments attributable to the state and local tax deduction in 2001 was $79.9 billion, and the amount attributable to the miscellaneous itemized deduction was $16.7 billion.[77]

CONCLUSION

Compared with the regular tax system, the AMT is a parallel "secret" tax system that most taxpayers have not yet experienced personally. As discussed in this report, the AMT imposes enormous burdens on those taxpayers whom it affects. Although the AMT was originally enacted to prevent wealthy taxpayers from avoiding tax liability through the use of tax avoidance techniques, it now affects substantial numbers of middle-income taxpayers and will, absent a change of law, affect more than 30 million taxpayers by 2010. In short, it is a time bomb on a short fuse. We urge Congress to face up to the hard choices that lie ahead sooner rather than later. The AMT is already creating major headaches for tax administration, and without reform, it will become a true crisis in the very near future.

[75] Richard M Lipton, Chair, American Bar Association Section of Taxation, *To Simplify the Code, Start by Repealing the AMT*, Comments on the Economic Perspective of Code Simplification, TNT 122-131, June 4, 2001.

[76] This statistic is computed from data furnished by the Joint Committee on Taxation on Nov. 5, 2003.

[77] IRS Statistics of Income Division, Individual Statistics of Income Study (Tax Year 2001).

RESPONSIBLE OFFICIAL

Dale Hart, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

Sole proprietors and self-employed taxpayers who operate predominantly in the cash economy, or whose income is not subject to payer reporting requirements, pose a significant challenge for tax administrators. Those taxpayers who do not file and report their business income on Schedule C, Profit or Loss from Business (Sole Proprietorship), or who underreport their business income if they do file, also present a significant challenge. Nonfilers and underreporters contribute to the growing tax gap in the United States.[1] The National Taxpayer Advocate believes this is among the most serious problems facing taxpayers because the tax gap is growing, and as a consequence, law-abiding taxpayers are being asked to pay more than their fair share of taxes to make up for the resulting revenue shortfall.

ANALYSIS OF PROBLEM

Although the IRS has conducted several studies to identify noncompliant taxpayers as well as the tax gap attributable to them, it has lagged behind in initiating programs to bring this segment of the population into compliance.[2] Noncompliance is any one or a combination of:

- nonfiling,
- underreporting, or
- non-payment.

The IRS estimates the tax year 2001 gross tax gap at $310.6 billion, comprised of $30.1 billion due to non-filing, $248.8 billion due to underreporting and $31.8 billion due to underpaying, for an overall "Noncompliance" rate of 15.0 percent.[3]

[1] The tax gap is the amount of tax that is imposed by law for a given tax year but is not paid voluntarily and timely. The estimated size of the gross tax gap for 1998 was $282.5 billion as compared to $310.6 billion for 2001. Tax Gap Maps for 1998 and for 2001 come from IRS National Headquarters Office of Research, July 17, 2003. This tax gap data is not adjusted for inflation. IRS does not have the statistics for the categories that contain a question mark (?) in Table 1.2.1.

[2] In 1999 the Chief, North Texas District Office of Research and Analysis was named Research Strategy Owner (RSO) charged with developing a comprehensive Improving Filing Compliance Research Strategy in coordination with the Assistant Commissioner (Collection) as the customer. Other studies include the IRS Small Business/Self-Employed Operating Division, Strategic Assessment Reports dated March 16, 2001 (FY 2003), March 1, 2002 (FY 2003 FY-2004) and January 31, 2003 (FY 04- FY05).

[3] IRS National Headquarters, Office of Research, Tax Gap Map for Tax Year 2001.

TABLE 1.2.1, TAX GAP ANALYSIS FOR TAX YEARS 1998 AND 2001 ($ IN BILLIONS)

	TY2001				TY1998			
Total Tax Liability	$2,076.8				$1,816.4			
Tax Paid Voluntarily & Timely		$1,767.4				$1,533.9		
Enforced & Other Late Payments*		$55.4				$50.0		
Tax Not Collected (Net Tax Gap)		$255.2				$232.5		
GROSS TAX GAP			**$310.6**				**$282.5**	
Nonfiling			**$30.1**				**$24.3**	
Individual Income Tax				$28.1				$22.6
Corporate Income Tax				?				?
Employment Tax				?				?
Estate Tax				$2.0				$1.7
Excise Tax				?				?
Underreporting			**$248.8**				**$218.5**	
Individual Income Tax				$148.8				$119.6
Corporate Income Tax				$29.9				$37.5
Employment Tax				$66.1				$57.9
Estate Tax				$4.0				$3.5
Excise Tax				?				?
Underpayment			**$31.8**				**$39.7**	
Individual Income Tax				$19.4				$24.2
Corporate Income Tax				$2.4				$3.0
Employment Tax				$7.2				$10.4
Estate Tax				$2.3				$2.0
Excise Tax				$0.5				$0.1

*IRS collects late payments for years to come. This category includes tax paid with & without IRS enforcement actions. For comparison, in FY2000, $24 Billion of tax was collected solely through enforcement efforts.

Unreported income by sole proprietorships is the single largest component of the tax gap.[4] Noncompliance is more prevalent among non-salaried workers who do not have taxes withheld and whose income is easily concealed, including those occupations where cash transactions are not recorded.

The IRS analysis of the tax year 1998 income tax gap estimates indicates that taxpayers who file sole proprietorship schedules (Schedule C) were responsible for $132.5 billion (64 percent) of the $206.9 billion income tax gap (individual + corporate income tax). This

[4] IRS Small Business/Self-Employed Operating Division, *Strategic Assessment Report*, March 1, 2002, FY 03-04, p. 4.

segment also accounted for almost $29 billion (more than 40 percent) of the estimated employment tax gap for 1998.[5] By contrast, the IRS estimated Earned Income Tax Credit overclaims were between $9.65 and $10.41 billion for tax year 1999.[6]

An IRS analysis of tax year 1999 filing compliance shows that taxpayers with a Schedule C filing requirement constitute the largest segment of individual nonfilers.[7]

- Schedule C taxpayers account for 58.6 percent of total dollars due from individual non-filers, representing a balance due of $15.9 billion.[8]
- Over 82 percent (82.4 percent) of all Small Business/Self-Employed (SB/SE) individual nonfilers are Schedule C filers.[9]
- Among nonfilers with a Schedule C filing obligation, 82.2 percent have a balance due.[10]

Taxpayers with a Schedule C filing requirement also have the lowest filing compliance pattern among SB/SE taxpayers, with 6.1 percent filing late and 9.3 percent not filing at all.[11]

The underreporting portion of the tax gap attributable to Schedule C filers also continues to grow. The average Predicted Tax Change (PTC), i.e., the difference between true and reported tax liabilities, rose eight percent per Schedule C return, from $1,386 in 1998 to $1,497 in 2000.[12] Schedule C filers accounted for 63.4 percent of the SB/SE individual filers PCT in 2000.

The IRS must consider the staggering cost of noncompliance on the compliant taxpayer when preparing its business strategies. Underreporting and nonfiling by Schedule C taxpayers unfairly burdens taxpayers whose income is reported to the IRS by third parties.[13] Table 1.2.2 shows the distribution of the 1992 tax gap by third party reporting requirements.[14]

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[5] IRS Small Business/Self-Employed Operating Division, *Compliance Risk Assessment Document*, FY 04-05 Strategic Planning Cycle, p. 28.

[6] Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns, February 28, 2002 p 11.

[7] IRS Small Business/Self-Employed Operating Division, *Compliance Risk Assessment Document*, FY 04-05 Strategic Planning Cycle, p. 47.

[8] Id.

[9] IRS Small Business/Self-Employed Operating Division, *Compliance Risk Assessment Document*, FY 04-05 Strategic Planning Cycle, p. 45; Tax Year 2002, Compliance Research Information System (CRIS) 1040 Database, and Case Creation Nonfiler Identification Process (CCNIP).

[10] IRS Small Business/Self-Employed Operating Division, *Compliance Risk Assessment Document*, FY 04-05 Strategic Planning Cycle p. 28.

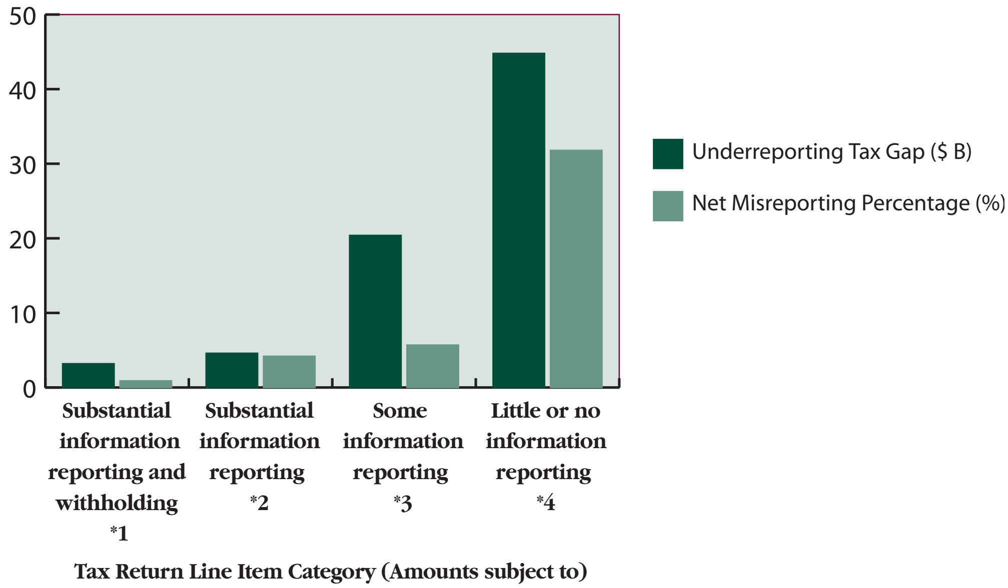
[11] Id. p. 45.

[12] Id. p. 29.

[13] *See* Supra Part 2, a legislative proposal about Non-Wage Withholding.

[14] Alan Plumley and C. Eugene Steuerle paper, "An Historical Look at the Mission of the IRS: What is the Balance between Revenue and Service," p. 4.

TABLE 1.2.2, UNDERREPORTED INCOME



1 **Wages & salaries**

2 **Pensions & annuities, dividend income, interest income, unemployment compensation, Social Security benefits**

3 **Credits, deductions, Partnership/S-Corp income, exemptions, capital gains, alimony income**

4 **Nonfarm proprietor income, informal supplier income, other income, rents and royalties, farm income, Form 4797 income, adjustments**

IRS COMMENTS

The IRS implemented a new strategic planning process designed to assist in the development of initiatives that will not only help us meet our customer needs but also enable us to focus on areas with the highest risk of non-compliance. This process uses information from the Compliance Risk Assessments, as well as internal and external scans, to identify gaps that could impact future compliance. As a result of this planning process, we have realigned our compliance resources to focus on the areas of greatest compliance risk. Two high-risk areas, identified through our analysis, were the increase in underreporting of income and non-filing of returns. As part of our strategic plan we have developed two programs (Unreported Income Discriminant Index Function (UI DIF) and Non-filer Strategy) that we will use to address these high-risk areas. DIF is a scoring technique designed to identify tax returns for examination that should have a high potential for tax change. On the other hand, UI DIF indicates the potential that unreported income exists on a tax return.

Unreported Income Discriminant Index Function (UI DIF)

The Service estimates that the tax gap for Tax Year 2001 - that is, the difference between the amount of tax owed and the amount of tax voluntarily paid - due to underreporting of income for individuals is $148.8 billion annually. The largest single component of the tax gap is unreported income by sole proprietors, who are required to file a Schedule C, estimated at $81.2 billion annually.

In FY 2003, SB/SE redirected Examination Program resources to focus on those areas of the filing population constituting the greatest compliance risk. One of these areas includes sole proprietorships filing Schedule C returns. UI DIF formulas can identify those Schedule C returns with a high probability of unreported income

The UI DIF formulas were initially developed from Taxpayer Compliance Measurement Program (TCMP) Tax Year 1988 data. We are currently working to develop filters, to complement the UI DIF formula, using multi-year return data that considers the taxpayers filing and reporting patterns over several years. Plans are also in place to update the formulas using National Research Program (NRP) study data from Tax Year 2001 returns when it becomes available in early FY 2005.

Nonfiler Strategy

In an effort to combat the growing number of non filers, the IRS has developed a Nonfiler Strategy that includes three key elements. First, we are reengineering our processes to improve case selection and perfection including the use of Decision Analytics to ensure the selection of the highest risk cases for processing.

Second, we are identifying the most egregious nonfilers. One area of focus is high-income nonfiler (HINF) taxpayers, those taxpayers with income of $100,000 or more who have not filed a return. The HINF program uses both face-to-face and correspondence audit techniques, depending on the issues on the return, to secure the missing returns.

Finally, we are initiating research studies of high-income non-filers, UI DIF population and repeat nonfilers that will assist us in the design of outreach and education products and services specifically targeted at these high-risk taxpayers. We will provide this information to taxpayers directly and through our partner stakeholder groups.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate supports the IRS in its development of programs designed to address the increase in underreporting of income and nonfiling of tax returns. While the IRS states that it is redirecting Examination resources to focus on those areas of the filing population constituting the greatest compliance risk, it appears that its approach to this problem is in the initial planning stages. Noncompliance by Schedule C taxpayers and those operating within the cash economy, however, has been documented for a number of years.

The National Taxpayer Advocate acknowledges that the Small Business/Self Employed (SB/SE) and Wage and Investment (W&I) Divisions of the IRS are partnering to coordinate the delivery of a Service-wide non filer program. The National Taxpayer Advocate is concerned, however, that SB/SE has not identified what specific efforts it will undertake with respect to Schedule C non-filers and underreporters. In contrast, during FY 2004 the IRS will conduct 25,000 EITC certification audits, 36,000 EITC filing status audits, approximately 400,000 EITC correspondence examinations, and 300,000 Automated Underreporter EITC examinations for a $9 billion overclaim problem. Yet, for a taxpayer population with an $81 billion tax gap, SB/SE does not appear to have a specific strategy.

The IRS states that it will conduct outreach and education via its partners and stakeholders subsequent to conducting research studies of high-income non filers. Although the IRS has not described the focus of those studies, the National Taxpayer Advocate is concerned that they will only impact noncompliance by high-income nonfilers. She encourages the IRS to develop methods of identifying the causes of noncompliance for all taxpayers, including whether taxpayers are inadvertently or deliberately failing to meet their tax obligations. Further, the IRS should analyze the impact of filing and record keeping burden on compliance. Without insight into the underlying reasons for noncompliance, the IRS will not be able to develop and conduct effective outreach, education, and compliance initiatives.

Given the difficulty of identifying, auditing, and collecting from Schedule C underreporters and nonfilers, the Nastional Taxpayer Advocate recommends that Congress implement a mechanism to withhold on payments to certain categories of non-wage workers.[15]

[15] *See Supra Part 2,* legislative recommendation regarding withholding on certain independent contractors.

MOST SERIOUS PROBLEM: EARNED INCOME TAX CREDIT COMPLIANCE STRATEGY

RESPONSIBLE OFFICIAL:

Henry O. Lamar, Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The Earned Income Tax Credit (EITC) provides low income taxpayers and working families with a refundable tax credit. In 2003, nearly 21 million taxpayers claimed over $36 billion in credits.[1] Despite its importance, the EITC remains one of the most challenging programs the IRS administers. While the General Accounting Office (GAO) considers the EITC to be one of the government's "high risk" programs because of the potential for erroneous claims, the complex requirements and other burdens placed on needy taxpayers eligible for the credit are also such that many taxpayers either simply fail to claim it, make inadvertent errors that reduce or eliminate the credit, or lose the credit by not participating in the process when the IRS examines their claim.

The Internal Revenue Service's EITC compliance strategy since 1990 has been one of fits and starts, and restarts. The IRS has failed to incorporate into its ongoing compliance efforts much of the information it has learned along the way, including the findings of its research branch and its marketing contractors about the characteristics of the target population.

The National Taxpayer Advocate's FY 2002 Annual Report to Congress identified seven of the 22 most serious problems facing taxpayers as relating to administration of the EITC. Many of these issues still exist, although the IRS has taken steps to address some EITC problems.

ANALYSIS OF THE PROBLEM

Background

The Earned Income Tax Credit is the largest means-tested anti-poverty program in the federal government today.[2] At its inception in 1975,[3] the maximum EITC amount was $400; the credit phased out entirely at a modified adjusted gross income (MAGI) of $8,000. For the 2002 tax year, the maximum credit is $4,140; the credit phases out entirely at $34,178 MAGI.

The most significant growth in the EITC (both in terms of the amount of benefit and the number of taxpayers) occurred after 1993. During this period, the EITC was virtually transformed from a small refundable tax credit, designed to offset the impact of payroll taxes on the working poor and provide them with a work incentive, into the largest federal means-tested anti-poverty program.

[1] EIC Report #701-98-11 W&I Monthly Operating Review of EITC through August 2003.

[2] In 2000, EITC payments went to 55.3 million persons, House of Representatives, Committee on Ways and Means, WMCP: 108-6, 2003 Green Book, Appendix K.

[3] Tax Reduction Act of 1975, Pub. Law. No. 94-12, Title II, § 204(a).

In the program's first year, tax year 1975, 6.2 million taxpayers claimed $1.25 billion in EITC credits, for an average credit of $202.[4] In tax year 2002, 20.6 million taxpayers claimed over $36.8 billion in EITC credits, with an average credit of $1,786.[5] Over this same period of time, the act of claiming the EITC has evolved from one simple line on an individual income tax return to a separate publication (Publication 596, Earned Income Credit - Are You Eligible?) that is 53 pages in length, a separate schedule (Schedule EIC), two worksheets (EIC Worksheets A and B), 13 pages of instructions, and multiple computations. The Treasury Inspector General for Tax Administration (TIGTA) has noted that the IRS passes much of this complexity on to the over 20 million taxpayers (and their paid or volunteer tax preparers) who claim the EITC today.[6]

Prior to 1997, the IRS' primary approach to EITC compliance involved local outreach strategies through district education specialists, office audits conducted at district offices, and audits handled by correspondence. The latter type of examinations primarily focused on missing, duplicate, or erroneous Social Security numbers for the taxpayer, taxpayer's spouse, or qualifying child.

In 1997 Congress authorized the IRS to use its summary assessment authority for math and clerical errors to deny the EITC where the claimant omitted a required Social Security number (SSN) or provided a duplicate or incorrect SSN.[7] The implementation of this authority coincided with the Service's reorganization between 1998 and 2000. This moved the IRS toward conducting correspondence audits for "simple" issues and virtually ceasing local office audits for EITC returns. The availability of other government and internal databases, including those developed by IRS Criminal Investigation (CI) to identify fraudulent claims, also contributed to the move away from one-on-one examinations to computer-based adjustments.

In 1998, the IRS received the first installment of a five year appropriation to reduce EITC errors and overclaims. Despite over 4.1 million examinations and math error assessments, over 16,000 preparer outreach visits, and a national advertising campaign, by the IRS' own reports, the percentage of EITC overclaims remains as high today as in 1994.

IRS EITC Compliance Strategy Shortcomings

The overall ineffectiveness of the IRS' compliance strategy to date to improve EITC compliance can be attributed, in part, to the IRS' failure to anticipate or understand the significance of the EITC's expansion since 1993. The IRS has struggled to come to grips

[4] Treasury Inspector General for Tax Administration (TIGTA), *Management Advisory Report: Administration of the Earned Income Credit*, Reference # 2000-40-160, September 2000, p. i.

[5] EITC Program Office.

[6] Treasury Inspector General for Tax Administration (TIGTA), *Management Advisory Report: Administration of the Earned Income Credit*, Reference # 2000-40-160, September 2000, p. 10.

[7] IRC § 6212(g)(2)(F).

with administering the EITC in its present form and scope. This transformation of the EITC has far-reaching consequences for program administration in several aspects.

- The EITC's beneficiaries have distinct and identifiable financial, educational, and cultural characteristics, including language, financial and functional literacy issues, transience, financial volatility and instability, and lack of access to representation.
- The IRS's traditional approach to conducting correspondence audits of non-EITC issues (involving little one-on-one communication with the taxpayer) is inappropriate if not inimical to obtaining the correct result with respect to the EITC population. Historically, it has not acknowledged, through program design, that the impact of an audit contact on a low income or immigrant taxpayer is different from that on a taxpayer who has resources for representation and for challenging the IRS.
- The IRS's use of correspondence examinations for EITC audits is contrary to the purpose of correspondence exam, namely for single issue audits of simple issues. Tax lawyers, economists, IRS employees and members of Congress all agree that the EITC is anything but simple in terms of its structure, its application, and its substantiation requirements.
- Until recently, the IRS has failed to incorporate what research it has conducted (much less the research others have conducted) about the EITC population into the design and execution of its examination procedures.
- Although the IRS has designed an effective national advertising campaign strategy, it is only now implementing what promises to be a well-thought-out localized outreach and education campaign to taxpayers who may be confused about EITC eligibility (including those who are eligible one year and ineligible the next) and those who are not aware that they are, in fact, eligible.[8]
- The IRS has failed to conduct meaningful research into why taxpayers make EITC overclaims. Are they advised to do so by their commercial return preparers? Are these inadvertent, intentional, or fraudulent overclaims? The IRS does not know why over 50 percent of EITC correspondence exams result in no response or are undeliverable.[9] Moreover, the IRS does not know the most effective manner for reaching (corresponding with) the EITC population, or how many contacts it takes to get a meaningful, substantive response. Before the IRS can design and implement an effective EITC compliance strategy, it must have the answer to these questions.

[8] *See* infra pp. 148 & 158 for discussions of EITC outreach and education and EITC nonfilers. Approximately one of out every three EITC participants becomes ineligible for the EITC each year. EITC "Churn" rate analysis, W&I Research Group 1, conducted on 1999 tax year for EITC Reform Task Force.

[9] Approximately 53 percent of taxpayers involved in EITC correspondence audits do not respond to IRS correspondence during the course of the audit or have correspondence returned to the IRS marked "undeliverable." This figure includes taxpayers who receive a statutory notice of deciciency (90 day letter). Yet, if taxpayers do respond at some point in the process, their ultimate tax liability is approximately 3*0 percent less (an average of $800)* than those who do not respond. Statement of Jim Grimes, W&I Director of Reporting Compliance, at TAS Technical Symposium, August 5, 2003.

- The Internal Revenue Service's EITC compliance studies misstate the overclaim rate - perhaps significantly - because:
  - (a) The EITC taxpayers generally lack professional representation during the course of an examination.
  - (b) The examination procedures followed in the studies were not taxpayer-friendly, given what we know about the EITC population.
  - (c) The number and nature of taxpayer contacts is critical to obtaining a complete and accurate picture of the EITC claimant's eligibility.
- The IRS has dramatically failed to address issues associated with commercial return preparation of EITC returns, including:
  - (a) the competency (or lack thereof) and regulation of certain preparers;
  - (b) The access to free tax preparation through VITA (volunteer) sites, IRS Taxpayer Assistance Centers, or a government-operated internet site (free of ancillary product offerings);
  - (c) the introduction of non-tax related products into the act of preparing and filing tax returns, including refund anticipation loans (RALs), charges for direct deposits, debit cards, and down payments and line of credits for consumer purchases.
  - (d) the failure until last year to link EITC marketing with financial literacy initiatives and access to financial services; and
  - (e) an inadequate preparer due diligence strategy and application of meaningful penalties (civil or criminal) against those preparers who are negligent, reckless, or criminal.

  Congress, too, has failed to address the issue that the EITC is the only federal anti-poverty program for which the majority of beneficiaries (67 percent) pay, on average, an "application fee" of $125 to $150 to apply for and/or receive.
- The IRS has only recently - in the last two to three years - effectively engaged with stakeholders in the low income community. It has failed to explain itself or its actions well, particularly to those who have little understanding of (or interest in) the details of tax administration.
- On the other hand, the numerous stakeholders interested in the EITC have contributed to its politicization. Discussions about the EITC quickly degenerate into accusations of class warfare. This trend is disturbing, since, if the IRS becomes a political football, the whole country suffers, including the EITC population.

- In 1999, over 18 IRS functions were involved in processing EITC claims. Most of these functions report to different management chains and at least two of them have conflicting goals. For example, the submissions processing function has the goal of processing paper tax returns and issuing refunds within 45 days (so as to avoid triggering the government's obligation to pay interest). The Criminal Investigation function, on the other hand, is charged with identifying fraudulent returns and stopping the payment of any associated refunds.[10] The IRS' failure to develop a structure that provides start-to-finish oversight of the EITC program has contributed to many problems associated with the program's administration.

Follow-up to 2002 Most Serious Problems

The National Taxpayer Advocate's 2002 Annual Report to Congress identified seven "most serious problems" involving the IRS' EITC administration. Although the IRS has made progress in addressing many of these problems, much work remains to be done. Each of the EITC administration issues is outlined below.

EITC Eligibility Determinations Can Be Made Less Burdensome

- The complexity, cost and intrusiveness of documentation requirements impose administrative, financial and sometimes unnecessary burdens on low income taxpayers.
- The IRS is inconsistent in requiring proof of EITC eligibility. Communication gaps exist between IRS and taxpayers in EITC examinations.

Procedures for Examining EITC Claims Cause Hardship and Infringe on Rights

- During the EITC examination process, the taxpayer's entire refund is held, including any refund associated with overpaid tax withholding credits.
- The initial notice requesting documentation to support the EITC claim and the report of examination changes also includes a brief notice of the taxpayer's right to an administrative appeal. Combining these two aspects of the process in one letter significantly compresses the available time for the taxpayer to gather and submit verification before receiving a statutory notice of deficiency. More importantly, the combined letter is confusing and does not provide the taxpayer with adequate and meaningful notice of his or her appeal rights.

Lack of Response During EITC Exams

- The lack of personal contact with EITC examiners imposes an unnecessary burden on low income taxpayers, who continue to report frustration in getting through by

[10] Treasury Inspector General for Tax Administration (TIGTA), *Management Advisory Report: Administration of the Earned Income Credit*, Reference # 2000-40-160, September 2000, p. ii.

telephone to the IRS specialists listed on notices. Employees sometimes fail to return calls from the taxpayers, their representatives, and TAS case advocates.

IRS Oversight of EITC Return Preparers Can Be Improved

- Tax return preparers file seven out of ten EITC tax returns. Tax return preparers who operate in low income communities and handle EITC returns require a heightened level of monitoring and regulation. The number and types of errors on returns handled by tax preparers rival those on returns that are self-prepared.
- The IRS needs to conduct a significant consumer education campaign so that low income taxpayers can make informed choices between tax preparers and preparation products.

The Length of EITC Audits Contributes to Taxpayer Concerns

- The EITC correspondence audit process requires taxpayers to substantiate eligibility for the credit they claim. The IRS must select, notify and correspond with taxpayers, then review and analyze the documentation they provide. Delays in these steps add time to the audits and prevent taxpayers from receiving refunds, which are usually held back until the audits are complete.
- The average time to complete an EITC audit during fiscal year 2003 was 206 days.[11]

EITC Recertification Compounds Taxpayer Burden

- Taxpayers encounter a multitude of problems when they try to recertify their eligibility for the EITC in years after the credit is disallowed. Recertification problems identified in the FY 2001 Annual Report to Congress are still occurring..[12] The General Accounting Office (GAO) recently reported that, "Although IRS made some changes to its correspondence, improved its examiner training, and expanded taxpayer outreach, certain aspects of the recertification process continue to cause problems for taxpayers."[13]
- The National Taxpayer Advocate made the following specific recommendations for the recertification program:
    - IRS Publication 596, Earned Income Credit, and the EITC instructions should contain a section entitled "What You May Have to Furnish the IRS if Your EITC Eligibility is Questioned."
    - Form 8862, Information to Claim Earned Income Tax Credit After Disallowance, should be included in Form 1040 series tax packages for taxpayers who are required to recertify.
    - The IRS should consider sending a letter each December to all taxpayers required to recertify for the EITC. The letter should explain the recertifica-

[11] IRS, *EITC Closed Case by Campus Report*, October 24, 2003.

[12] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), p. 36-38.

[13] General Accounting Office, *Earned Income Credit: Opportunities to Make Recertification Program Less Confusing and More Consistent*, GAO 02-449, April 2002, p. 5.

tion process, including their right to appeal, and enclose the blank Form 8862 and instructions.

- The IRS should require tax examiners to simultaneously address all open tax returns claiming EITC, to prevent taxpayers from having to submit some of the same information numerous times to different employees.

Language Barriers Impact Taxpayer Compliance

- Preparing tax returns, claiming the EITC, communicating with the IRS, responding to IRS letters or notices, and understanding their rights are vexing for taxpayers with limited English proficiency. English-as-a-Second-Language (ESL) taxpayers receive IRS notices that are not written in their native languages. These taxpayers acutely need help in handling controversies that develop after they file returns.
- ESL taxpayers may not understand IRS notices, letters, and the consequences of failing to respond to them. The IRS must find a way to determine the language spoken by taxpayers at the start of their interaction with the tax system, such as by placing a check box on each tax return.

IRS COMMENTS

The IRS recognizes we must do more to address both the erroneous payment rate in the EITC program and ensure that eligible taxpayers claim the credit (see IRS response on EITC outreach), and we are taking some concrete steps in this direction.

We have already made significant strides in addressing EITC issues. The EITC Task Force, which has Advocate participation, developed a multi-pronged approach that includes targeted education and outreach, use of math error authority to partially or fully disallow claims, and enforcement actions including correspondence examinations and criminal investigations. Most of the implemented changes occurred after the filing of 1999 tax returns, therefore, any impact from these changes would not be reflected in the studies cited by the Advocate. For example, in the area of over claims, the IRS has made the following improvements:

- The use of the Dependent Database to select the most potentially egregious cases has reduced the no change rate to 11 percent. Each year the selection criteria are reviewed by Research to ensure their validity and changes to the selection criteria are made.
- The implementation of the Recertification indicator has decreased the amount of Earned Income Tax Credit paid to ineligible taxpayers.

- The tax law requirement of the qualifying child to be related to the taxpayer has eliminated some ineligible taxpayers from claiming the credit.
- The tax law change in the tie breaker rule now allows taxpayers to choose who can take the credit when more than one person is eligible to claim the qualifying child.

In addition to these past efforts, current short-range initiatives include:

- Piloting a program that will require certain portions of the EITC population to certify they meet the child residency requirement.
- Developing programs to systematically look at filing status errors and income underreporting. The goal of the evaluation plan for the certification pilot is to gain a better understanding of taxpayer behavior so that we can learn why taxpayers make EITC over claims.

Longer-term adjustments can be summarized as:

- Improving our EITC case selection methodology.
- Enhancing our inventory and workload management.
- Implementing on-line analytics that will enable us to adjust our compliance strategies in realtime, give our customer service representatives tools to respond accurately and consistently to EITC taxpayers, and improve taxpayer access to information about their account status and qualifications for EITC.
- Addressing the diverse characteristics of the EITC population by translating all audit letters into Spanish, installing toll free phones for the taxpayer to receive information, educating our tax examiners to accept alternative documentation and participating in the Nationwide Tax Forums to distribute information to EITC tax preparers.
- Developing plans for next year that will enable us to test a variety of different approaches in communicating with EITC beneficiaries. We plan to incorporate the information we gain from this effort as well as other research efforts into the design and execution of our examination procedures

To ensure that these efforts receive the attention that they need, the IRS has centralized and consolidated numerous EITC-related responsibilities under a single executive who is accountable for all aspects of the EITC – from outreach to compliance. He will ensure coordinated and consistent approaches to EITC issues with all involved organizations. By linking all EITC activities, the new EITC program will be able to address one of the key issues in the Advocate's report: creating research-based strategies to address the program's dual goals – compliance and participation. Refining this strategy is a top goal of the new EITC executive.

To reduce the burden on eligible taxpayers, the IRS has included EITC returns in the National Research Program (NRP) – an effort to systematically measure tax system compliance across a variety of different taxpayer segments. Results from this effort may prove to be more accurate in determining whether the IRS has been successful in reducing the over claimed EITC.

We disagree with the Advocate that the IRS approach to handling the EITC audits through correspondence is inappropriate. There is no research evidence that correspondence audits cannot be an effective tool to address EITC over claims. We did complete a research study that was designed to look at EITC non-response rates. It was conducted in an office audit environment where the taxpayers had the option of a face-to-face audit and we found that the taxpayer still did not reply to IRS communications. However, the study did not have the kind of participation by EITC taxpayers that would enable us to draw conclusions about the reasons for taxpayer behavior. In our expansion of EITC research, this is an area that will warrant greater attention. However, our current belief is that the resources and time expended to administer the EITC program though face-to-face audits would not be cost effective.

We also disagree with the Advocate's comment that IRS does not know why over 50 percent of the EITC correspondence exams result in a no response closure or are undeliverable. The current no reply and undeliverable rates are 30.7 percent and three percent respectively. Of the no reply cases, 47 percent fall under the Recertification Program. This information shows that the taxpayer who is claiming the child this year has had the qualifying child disallowed in a previous year. Since the main component of the EITC is the residency requirement, we believe a likely explanation of the taxpayer's failure to reply is that they were not eligible. Again, we will need more research before we can draw further conclusions about no response rates.

We agree with the Advocate that "although the IRS has made progress in addressing many of these (EITC) problems, much work remains to be done." However, since most of these enhancements will affect the taxpayers' 2003 tax returns, they cannot be measured until the returns are filed and research is completed.

In conclusion, the IRS continues to review and improve the processes it uses to ensure EITC compliance. This is a Servicewide effort that includes various research studies, extensive outreach efforts to both taxpayers and the practitioner community, and continually improving its return selection methods. The IRS is also continuing to try to find more accurate and reliable third party information we can use in this selection process to further reduce the burden on the taxpayers.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes that the IRS has taken a major step forward by centralizing all EITC programs under the direction and coordination of a single executive. This approach should produce more consistent guidance for IRS employees conducting EITC exams, and among other administrative improvements, will reduce inconsistent or disparate treatment of taxpayers during these examinations.

The Taxpayer Advocate service looks forward to the results of research performed on cases examined under the 2003/2004 National Research Project. TAS is concerned, however, that the EITC examinations are being conducted under conditions similar to those that have led to "no response/undeliverable" rates of nearly 40 percent for EITC examination notices.[14]

Many of the recommendations for administrative improvements in the EITC made by the National Taxpayer Advocate in the 2002 Report to Congress are works in progress. In the summer of 2003, the IRS Commissioner established special task forces to re-engineer the EITC examination and notice processes. With Taxpayer Advocate Service participation and external stakeholder involvement in the task forces, the IRS will continue to work the finer details of important changes for the EITC through these bodies.

The National Taxpayer Advocate is particularly pleased that IRS Operations has agreed to implement a number of EITC administration changes recommended by TAS. Many will be effective for 2003 tax returns, such as holding only the EITC portion of a taxpayer's refund during EITC examinations (instead of the full amount), modifying the "combo" letter to offer taxpayers in the certification pilot additional opportunities to exercise their right to appeal,[15] *and translating important documents, such as EITC Certification forms and notices and the Statutory Notice of Deficiency, into Spanish.*

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS establish an EITC compliance strategic five year plan that incorporates the following elements.

First, the Service must continue to seek out ways to systemically determine the eligibility of groups or individuals, whether with respect to the EITC overall or to specific elements of the EITC.

[14] Data provided by the EITC Program Office to TAS for FY 2003 indicates nearly a 40 percent no response/undeliverable rate for the EITC correspondence. As notd earlier, the no response/undeliverable rate including the Statutory Notice of Deficiency is 53 percent. In its response, IRS states that the current no reply/undeliverable rate totals 33.7 percent. IRS did not provide a source or timeframe for this statistic.

[15] But *see infra* for a discussion of National Taxpayer Advocate's concerns about this approach to the Combination Letter.

Second, the IRS must continue to pilot its precertification/certification program in order to

- *Test forms and notices for clarity and effectiveness in eliciting a response.*
- *Refine and identify the population most likely to be ineligible and use precertification as a means to educate taxpayers about EITC requirements so they know that they can claim it if they become eligible in the future.*
- *Test different methods of reaching out and communicating to taxpayers who are selected for precertification and/or examination.*

Third, the overall EITC compliance initiative must incorporate the following elements:

- *Develop a multi-year research strategy that not only provides valuable information about the EITC population for use in program design but also evaluates the impact of use of that information.*
- *Effectively target outreach and education to local populations and monitor it for demographic and geographic trends and shifts, focusing not only on the sources of noncompliance but also on increasing participation by eligible taxpayers.*
- *Use examination resources in a targeted fashion, in cases involving the error or abuse du jour.*
- *Promote the use of Low Income Taxpayer Clinics through inclusion of various stuffer notices and obtaining legislative authorization for advertising and promoting the existence of clinics, including providing taxpayers with clinic referrals.*
- *Require paid return preparers (other than attorneys, CPAs, and enrolled agents, who are already regulated in some form) to register, pass an annual examination, and be certified by the IRS. Further, Congress must authorize broader due diligence requirements for EITC preparers of all types; the IRS must conduct correspondence exams to check for compliance with those requirements; the IRS must apply penalties against noncompliant preparers who cannot demonstrate reasonable cause; and Congress must authorize the IRS to hold preparers who act in reckless disregard of EITC rules and regulations 100 percent liable (jointly and severally with the taxpayer) for any EITC overclaims attributable to that reckless disregard.*[16]
- *Continue its effective partnerships with low income taxpayer representatives, community-based organizations providing free tax return preparation and organizations (governmental and nonprofit) that assist taxpayers in entering the financial mainstream.*
- *A joint determination, by IRS, Treasury, the Office of Management and Budget, and Congress, of when we have reached a "good enough" point for EITC compliance. Given the complexity of the statute and the characteristics of the beneficiary population, there will always be EITC overclaims. At what point do we say that we have done the best we can, and it is time to focus on other things?*[17]

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[16] *See Supra Part 2*, legislative recommendation regarding commercial return preparers.

[17] For 1992 (over 10 years ago) the IRS estimated that nonfarm sole proprietor income accounted for $16.9 billion in underreported income. This number dwarfs the 1999 $9 billion EITC overclaims, yet the IRS has no significant strategy to address this serious tax administration problem. IRS, Publication 1415 (Rev. 4-96).

The approach outlined above acknowledges the social welfare aspect of the EITC while recognizing that the tax administration system has unique operational requirements. Thus, such an approach can be modified to meet the requirements of similar programs administered through the tax system from the outset. The IRS can, in fact, administer programs that assist low income or other specific taxpayer populations. It must, however, have good research and a comprehensive strategy before it implements these programs.

PROBLEM

TOPIC #4 **MOST SERIOUS PROBLEM: APPEALS IMPLEMENTATION OF THE COLLECTION DUE PROCESS (CDP) PROGRAM**

RESPONSIBLE OFFICIAL

Dave Robison, Chief Appeals

DEFINITION OF THE PROBLEM

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) established the Collection Due Process (CDP) hearing rights under Internal Revenue Code (IRC) sections 6320 (liens) and 6330 (levies).[1] This important informal adjudication procedure provides taxpayers with the opportunity for a timely independent review of their cases to ensure that the lien or proposed levy action by the IRS compliance function achieves the appropriate balance between the government's and the taxpayer's interests, and that the Service has adhered to any applicable legal and administrative requirements.

Critics of the CDP process, both inside and outside the IRS, have characterized this program as a waste of time and resources, and speculated that it is utilized by taxpayers who are only seeking to delay the ultimate collection of tax. However, many of the problems that critics use to justify significant limitations on or elimination of the current CDP program – including delay of collection actions, untimeliness in processing cases, and misuse of the hearing process – are largely the result of the IRS' failure to design and implement a program that delivers on Congress' promise of a meaningful hearing before the government deprives the taxpayer of property in collecting a tax debt.

ANALYSIS OF PROBLEM

THE COLLECTION DUE PROCESS HEARING: BACKGROUND

On February 5, 1998, the Senate Finance Committee convened a hearing on proposals to restructure the Internal Revenue Service.[2] At that hearing, four members of the tax professional community uniformly testified about the need for some type of forum that would hear taxpayer concerns about IRS collection activity before the taxpayer was required to pay a deficiency in tax. The proposed intermediaries included administrative law judges, Appeals officers, Taxpayer Advocate employees, and United States Tax Court judges. The witnesses acknowledged that IRS collection employees have a very difficult job, no matter how professional and sympathetic they try to be. The proposal's underlying premise was that the relationship between the taxpayer and the IRS collection employee (the revenue officer or "RO") is by definition an adversarial one. The witnesses reasoned that, in many cases, the introduction of a neutral third party would ensure that both the government's interest and the taxpayer's rights are protected.

1 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3401, 112 Stat. 685.

2 IRS Restructuring: Hearings Before the Committee on Finance, United States Senate, 105th Cong., 2nd Sess., on H.R. 2676, February 5, 1998, (Public Witnesses: Nina E. Olson, executive director, Community Tax Law Project, Richmond, VA, Michael Saltzman, tax attorney, White & Case, New York, NY, Robert Schriebman, tax attorney, Rolling Hills Estates, CA, and Bruce A Strauss, enrolled agent, Jacksonville, FL).

The resulting law, the Internal Revenue Service Restructuring and Reform Act of 1998, enacted IRC sections 6320 and 6330 and established the Collection Due Process hearing. The Collection Due Process program "establishes formal procedures designed to ensure due process where the IRS seeks to collect taxes by levy (including by seizure)."[3] The legislation afforded taxpayers the opportunity to ask for a meaningful review of certain IRS collection actions by an impartial officer of the IRS' Office of Appeals.[4] The taxpayer is also able to appeal the hearing officer's determination to the United States Tax Court or the federal district court, as appropriate.[5]

In proposing the Collection Due Process procedures, the Senate Finance Committee stated:

The Committee believes that taxpayers are entitled to protections in dealing with the IRS that are similar to those they would have in dealing with any other creditor. Accordingly, the Committee believes that the IRS should afford taxpayers adequate notice of collection activity and a meaningful hearing before the IRS deprives them of their property.[6]

OVERVIEW OF THE CDP PROCESS

Collection Due Process rights are triggered by two events:

- The first time the IRS files a notice of federal tax lien with respect to a tax liability;[7] and
- The first time the IRS proposes a levy action with respect to a tax liability.[8]

In both situations, the IRS must send, by certified or registered mail, a notice to the taxpayer's last known address, providing the taxpayer an opportunity to request a CDP hearing.[9] The taxpayer must return a signed, written request for a hearing, within 30 days of the date of notice.[10] If the taxpayer makes an untimely request, a hearing will be allowed

[3] S. Rep. No. 105-174, 105th Cong., (1998) p. 67; Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998, p. 81 and 83 (JCS-6-98).

[4] IRC § 6330(b).

[5] IRC § 6330(d)(1).

[6] S. Rep. No. 105-174 105th Cong., (1998) at 67.

[7] IRC § 6320.

[8] IRC § 6330.

[9] IRC § 6320(a)(2)(C) and IRC § 6330(a)(2)(C). The notice regarding a lien filing is sent after the lien is filed; it is required to be sent not more than five days after the day of the filing of the notice of lien. The notice regarding a levy is sent prior to the levy action; it is required to be sent not less than 30 days before the day of the first levy.

[10] Treas. Reg. §§ 301.6320-1(c)(2), Q&A-C1, and 301.6330-1(c)(2),Q&A-C1. The IRS has recently approved the expanded use of faxes for receiving information and documents from taxpayers and practitioners. Form 12153, Requests for Collection Due Process Hearing, can be accepted by fax if contact has been made with the taxpayer by phone or in-person and the taxpayer history file is documented with the date of contact and notation is made that the taxpayer wishes to send the document/form/letter by fax. IRS memorandum, "New Policy for Use of Fax and Signatures Stamps in Taxpayer Submissions," June 24, 2003.

but the taxpayer loses the right to judicial review.[11] Unless the IRS has reason to believe collection of the tax is in jeopardy, the IRS will stop levy action during the 30-day period.[12] When a taxpayer requests CDP hearings with respect to both a lien and a proposed levy, the Appeals Officer will conduct one hearing.

If the taxpayer's appeal is timely filed, the IRS will suspend collection action throughout the process. Internal Revenue Code section 6330(e)(1) requires the collection statute of limitations to be suspended until the date the appeals determination is final or the taxpayer withdraws the request for a hearing.[13] The hearing is conducted by an Appeals officer or employee, who has had no prior involvement with respect to the specified unpaid tax.[14] The hearing can be conducted face-to-face, by telephone or by correspondence.[15]

During the hearing, the taxpayer may raise "any relevant issue relating to the unpaid tax or the proposed levy," including spousal defenses, the appropriateness of collection actions, and collection alternatives.[16] A taxpayer may only challenge the underlying tax liability if the taxpayer did not receive a statutory notice of deficiency with respect to that tax liability or "did not otherwise have an opportunity to dispute such tax liability."[17]

When making their determination in the case, hearing officers must consider the following:

- Verification that the IRS followed legal and administrative procedures;
- Consideration of all relevant issues presented by the taxpayer or representative; and
- Consideration of whether the proposed collection action balances "the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary."[18]

The taxpayer may contest the findings and decision by appealing within 30 days of the date of the determination letter to either the United States Tax Court or the United States District Court, depending on the type of tax in question.[19]

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[11] Treas. Reg. § 301.6330-1(c) (2), Q&A -C7. This type of hearing is called an "equivalent hearing."

[12] IRC § 6330(e)(1).

[13] IRC § 6330(e)(1).

[14] IRC §§ 6320, 6330(b)(3).

[15] Treas. Reg. § 301.6330-1(d)(2), Q&A-D7. *See* cases Montijo v. United States, 2002-1 U.S.T.C. (CCH) P50321 (D.Nev.2002), Craig v. Comm'r, 119 T.C. 252 (2002), Frank v. Comm'r, T.C. Memo. 2003-88, Eiselstein v. Comm'r, T.C. Memo. 2003-22, Bartschi v. Comm'r, T.C. Memo 2002-268, Robinson v. Comm'r, T.C. Memo. 2003-77, and Keene v. Comm'r, 121 T.C. 8 (2003).

[16] IRC § 6330(c)(2)(A)(i)-(iii).

[17] IRC § 6330(c)(2)(B).

[18] IRC § 6330(c)(3)(a)(c).

[19] IRC § 6330(d)(1)(a),(b). In 2003, the House of Representatives passed a bill moving jurisdiction over all CDP cases to the Tax Court. Taxpayer Protection and IRS Accountability Act of 2003, H.R. 1528, 108th Cong. § 303 (2003). A similar bill, the Tax Administration Good Government Act, S.882, 108th Cong. § 301 (2003), has been introduced in the Senate.

Jurisdictional Control of CDP Cases

Under the Administrative Procedure Act of 1966 (APA), informal adjudications such as the CDP hearing must be conducted in such a way as to afford the taxpayer notice of the hearing, an opportunity to be represented by counsel, and a written explanation of the adjudicator's decision.[20] In enacting IRC sections 6320 and 6330, Congress stipulated additional procedural requirements for the CDP hearing process. These requirements are integral to achieving Congress' stated intent that the CDP process provide taxpayers with an opportunity for a meaningful hearing by an independent Appeals officer on several issues, including the appropriateness of collection activity, prior to being deprived of their property.[21]

Several of the IRS's current CDP procedures actually undermine the taxpayer's right to a hearing. The IRS' current policy directs Compliance employees to continue to work CDP cases after taxpayers have requested a CDP hearing. These efforts can continue for 45 days.[22] If the issue remains unresolved, the matter may be referred to the IRS employee's manager. The manager attempts to resolve the matter for up to an additional 45 days. Only after this 90-day process is the hearing request forwarded to Appeals.[23]

IRS procedures permit a taxpayer to request that his or her case be immediately transferred to Appeals upon filing a CDP request or be transferred at any time during negotiations with Compliance following the request for a CDP hearing. Yet taxpayers have already made this request by filing Form 12153, Request for a Collection Due Process Hearing. Thus, current IRS procedures do not properly implement the statutory requirement that taxpayers be afforded a meaningful hearing before the IRS takes their property. Under the IRS' default procedure, it can take up to 90 days after the taxpayer elects a CDP hearing for the case to actually arrive in Appeals for assignment to an officer.

In many cases, the taxpayer has already attempted to resolve the levy and/or lien issue with Compliance personnel, and the CDP notice is issued because the matter is not being resolved to the Service's or the taxpayer's satisfaction. In this context, even the "request" by Compliance that the taxpayer continue to negotiate with Compliance can constitute undue pressure on the taxpayer, who has elected to have an independent party – an Appeals Officer – review the case. To the unsophisticated taxpayer, it may indeed appear that his CDP request is meaningless – he is still dealing with the same IRS employees (for up to 90 days) as he was before he asked for a hearing.

[20] Administrative Procedure Act of 1966, 89 Pub.L. No. 554, 1966, § 555.

[21] *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998 at 81, 83 (JCS-6-98).

[22] Internal Revenue Manual 5.1.9.3.5.(9).

[23] Memoranda, Interim Guidance of Collection Due Process (CDP), April 4, 2003 (Control No. SB/SE 2003-34), and July 2, 2003 (Control No.SB/SE 2003-67).

The Internal Revenue Manual requires Appeals to send the taxpayer an acknowledgement letter no later than 30 days after *receipt* of the CDP case in Appeals, and to include in the letter a contact person's name and phone number and the expected next action.[24] Thus, up to 120 days may lapse from the time a taxpayer files his or her request for a hearing until the taxpayer first hears from the independent Appeals Officer, who is central to the concept of collection due process.

A far better approach – one that would truly implement Congress' mandate to provide taxpayers with due process prior to taking property – would be for jurisdiction and control of a CDP case to immediately vest in Appeals upon the IRS' receipt of a timely CDP hearing request. Within 15 to 30 days of the IRS' – not Appeals' – receipt of that timely request, the Office of Appeals should send an acknowledgement letter to the taxpayer, stating that the taxpayer will be granted a hearing within 30 to 45 days, and that if the taxpayer wishes to continue negotiations with Compliance personnel, he should continue to do so.

Where the taxpayer has not responded to the IRS about the collection matter prior to the issuance of the CDP notice, Appeals should send a letter stating that the hearing will be scheduled within 60 days, and that a Compliance employee will contact the taxpayer to first attempt to resolve the matter at that level.

This procedure provides a clear indication to the taxpayer that the independent review he or she requested will occur in a timely fashion. It also permits, and in some cases requires, the taxpayer to continue efforts to resolve the issue with Compliance prior to the hearing. The important differences between IRS current procedure and the National Taxpayer Advocate's proposed procedure are:

- Taxpayers are given assurances that they will receive an independent hearing if it is desired;
- The information is delivered by the independent Office of Appeals;
- Appeals' initial contact with taxpayers is timely and made upon the IRS' receipt of the hearing request; and
- The independent Office of Appeals is the office offering taxpayers the alternative of continuing to work with Compliance.

Each of these elements reinforces the independence and meaningfulness of the CDP review. The independent review by the Appeals function is, after all, the underlying premise for the section's enactment in 1998. The Appeals Officer brings something more to the discussion and resolution of the issue than just providing the "opportunity" for the

[24] Internal Revenue Manual 8.7.2.3.2(1).

taxpayer to have additional dealings with the collection employee, who is the very individual who filed the lien or is proposing the collection action that triggered the right to a CDP hearing.

The proposed procedure will also eliminate the current delays in scheduling and holding hearings. The importance of the timeliness of these contacts – which give meaning to the taxpayer rights afforded by the CDP procedure – is discussed below.

Appeals' Review of Collection Alternatives

What constitutes a "meaningful hearing" continues to develop as more CDP cases wind their way through both the administrative and judicial process. It is incumbent upon the Appeals function to design a process that provides the taxpayer with understandable information about his or her collection alternatives so that the taxpayer can raise them in the hearing. After all, many taxpayers are not able to wade through IRS publications describing the collection process and identify what collection alternatives are appropriate for their particular situation.

In fact, Appeals' policy manual directs employees to consider alternatives not introduced by the taxpayer, when it's appropriate. This approach includes considering and discussing issues the taxpayer would not be allowed to raise because they were fully considered in a prior administrative hearing.[25] For example, if a taxpayer had previously proposed subordinating an IRS lien and Compliance personnel denied that request, the Appeals hearing officer should consider raising and re-examining that issue again if it is appropriate to do so.[26]

This manual provision, while taxpayer-friendly, reflects Appeals' confusion about what, exactly is the hearing officer's true role. If the hearing officer is an adjudicator, then he should not be acting in the traditional role of an appeals officer who facilitates settlement. The CDP hearing must be designed to insure that the taxpayer understands what his or her collection alternatives are, without compromising the hearing officer's integrity as an adjudicator – one whose determinations are, in fact, subject to judicial review.

Communication about the CDP Hearing Process and Collection Alternatives

Appeals' CDP customer base includes taxpayers or their representatives who have a dispute or disagree with the IRS about a lien filing or proposed collection action. These disagreements often involve *pro se* taxpayers who may not be knowledgeable in tax matters and CDP.[27] As Appeals' workload has changed to include more CDP cases, so must its

[25] Internal Revenue Manual 8.7.2.3.10(8)a.

[26] Subordinate - To place in a lower rank, class or position; to assign a lower priority. *Black's Law Dictionary* 1439 (7th ed. 1999). A common example of IRS subordination would be a home refinance. IRS might agree to a secondary position behind the new loan because it will receive a monthly payment that represents the savings realized with the new loan.

[27] "*Pro Se*" means "for oneself; on one's own behalf; without a lawyer." *Black's Law Dictionary* 1236-37 (7th ed. 1999).

communication and operational processes evolve to meet the needs of its changing inventory and customer base. Appeals has an opportunity to develop communications that are simple and informative for the average taxpayer segment.

The United States Tax Court web site provides an example of concise explanations and easily understood instructions for guiding the taxpayer through its formal adjudication process.[28] The Tax Court's site, and associated forms and instructions, assist a taxpayer through what could be an intimidating process and instead provides a simplified format for petitioning the court and electing small case or "S" status.[29] The Tax Court's forms and processes throughout the course of litigation are designed to elicit from the taxpayer the information required by the judge to find facts and make a decision in the case. Thus, the Tax Court not only provides the taxpayer with Petition Form 2, but also presents a Trial Memorandum form on which taxpayers can submit issues to be considered, list relevant facts, cite legal authorities, and identify witnesses. The Court also provides all petitioners with standing trial orders addressing the conduct of the trial.

The Office of Appeals can learn much from the Tax Court's procedures and communications. In its initial contact letter to taxpayers, Appeals should include a clear, concise, plain-English discussion of collection alternatives that can be considered in a hearing, along with information about hearing dates, next contact dates, and expected time tables. Further, Appeals should include a form, similar to the Tax Court's Trial Memorandum that will enable the taxpayer to set out which collection alternatives he or she wishes to raise at the hearing and any facts relevant to consideration of each alternative. This approach will result in a better-informed and prepared taxpayer, greater timeliness and efficiency in conducting hearings (because the necessary information is available) and improved customer satisfaction. Meaningful communication with the taxpayer starts with issuance of the CDP notice and ends with his or her understanding of the determination letter and what the options are from that point forward.

The absence of a clear, plain-English discussion of collection alternatives causes one to question whether Appeals officers have the information necessary to balance the government's interests in collecting tax against the taxpayer's interest that the collection actions are no more intrusive than necessary. Although many IRS publications discuss CDP hearings and collection alternatives, none provides a plain-English (or Spanish, for that matter) road map through the collection process.[30] Publication 594, What You Should Know About the IRS Collection Process, provides a brief review of collection alternatives;

[28] Available at http://www.ustaxcourt.gov.

[29] IRC § 7463 provides that any individual with a petition before the Tax Court, who meets the jurisdictional requirements, including the new statutory cap of $50,000, can elect to have the case heard as a small tax case. (The amount includes not only deficiencies, but also additions to tax, additional amounts, and penalties. See section 7463(e) and Tax Court Rule 171(a).)

[30] These publications include Publication 1660, Collection Appeal Rights; Pamphlet, Appeals Working to Put Service First - An Introduction to CDP Hearings; Publication 5, *Your Appeal Rights and How to Prepare a Protest if You Don't Agree*, Publication 1, *Your Rights as a Taxpayer*. and Publication 594, *What You Should Know About the IRS Collection Process.*

the remaining publications, including those specifically describing CDP hearings, do not adequately describe collection alternatives. Publication 1660, Collection Appeal Rights, briefly mentions alternatives, but provides no in-depth explanation as to what is required to qualify for these alternatives.

In fact, IRC § 6330(a)(3)(C) requires the IRS to include in the notice providing CDP rights not only notice of the Secretary's proposed levy action and the taxpayer's rights with respect to that action but also a brief statement setting forth

- the statutory and administrative procedures relating to levy and sale of property, including administrative appeals;
- the collection alternatives available to taxpayers in order to prevent a levy of property, including installment agreements; and
- the statutory and administrative procedures for redemption of property and release of liens on property.

This Congressional mandate would appear to require the IRS to provide a brief, but descriptive, inventory of the various protections, procedures, and alternatives available to the taxpayer in relation to the IRS' lien or levy action that is the subject of the notice.

The IRS meets this statutory requirement only superficially. It includes an explanation of the taxpayer's rights and alternatives by enclosing Publication 594, The IRS Collection Process. This 12-page publication can be intimidating to taxpayers, and is not a model of clarity. It would be far better for IRS and Appeals to design a CDP-specific summary of taxpayer rights and collection alternatives, as part of the CDP notice itself, so the taxpayer can formulate a meaningful request from the beginning of the process.

One of the publications available to hearing officers is Publication 4165, Working to Put Service First – An Introduction to CDP Hearings, which summarizes the Appeals process and CDP. This publication lacks detail in its description of general collection alternative methods for the taxpayer. This information is important at the onset of the hearing process, so that the taxpayer can fully assess his or her collection alternatives and respond to the Office of Appeals.

High Inventory Levels and Timely Case Processing

In recent years, Appeals' inventory and customer base have changed dramatically. Prior to the enactment of RRA 98, Appeals' inventories involved practitioners representing taxpayers on examination issues. That client base has shifted to inventories involving collection issues (including CDP and offers-in-compromise) and issues originating in IRS campus functions (e.g., earned income credit or under-reporter examinations).[31] This changing inventory has resulted in increased cycle time and unwieldy inventories. The table below illustrates the percentage of Appeals' inventory receipts for CDP over the past few fiscal years.[32]

TABLE 1.4.1, APPEALS CDP RECEIPTS

Fiscal Year	2000	2001	2002	2003
Total Appeals Receipts	55,431	68,198	76,397	98,378
Total CDP Receipts	6,892	19,119	26,666	31,848
Percentage of Receipts CDP	12%	28%	35%	32%

The Collection Due Process program went into effect on January 19, 1999, in fiscal year 2000 (180 days after the enactment of RRA 98). In FY 2000, the program was just getting off the ground, and the IRS, taxpayers, and practitioners were trying to determine how this program would work. Thus, it was reasonable to expect that CDP case receipts would increase significantly in FY 2001 and 2002, as more taxpayers or practitioners understood the importance of the procedure. Moreover, IRS collection actions have increased over this same time period. Thus, the number of CDP hearing notices issued by the IRS has increased significantly over the past four years.

Appeals uses Customer Satisfaction Surveys as one method to measure its success in processes and procedures.[33] Over the past few fiscal years, these surveys have established a pattern of customer dissatisfaction with respect to delays in processing CDP inventory. The most recent Customer Satisfaction Survey, released in September 2003, surveyed a total of 390 customers whose Appeals cases closed from October 2002 through March 2003. Of the 390 customers surveyed, 19 percent had been involved in CDP cases. Both satisfied and dissatisfied customers expressed concern about the length of the appeals process and adequacy of resources applied by Appeals.[34]

In fiscal year (FY) 2001, Appeals stated that the current average time applied per CDP case was 12-15 hours. In FY 2003, a Treasury Inspector General for Tax Administration (TIGTA) report stated that the average time per CDP case was 11-17 hours and that high inventories and the routing of CDP cases did not account for delays.[35] Inventory levels for hearing officers are on the average between 56-65 cases.

[31] For a more detailed discussion of Appeals inventory, *see* MSP Appeals Inventory Delays, in Part 1, Tables 1.16.2 &1.16.3 Non- Docketed & Docketed Appeals Workload.

[32] Historical Data Report, 2000-2003, compiled by Director Tax Policy & Procedure, Appeals, November 26, 2003.

[33] Customer Satisfaction Survey, data available quarterly from September 1998 to current (FY 2002 and 2003 recent surveys conducted by the Gallup Organization and Pacific Consulting Group).

[34] For a more detailed discussion of Appeals' inventory delays, *see* MSP Appeals Inventory Delays, in Part 1.

[35] Treasury Inspector General for Tax Administration (TIGTA), *Appeals Could Take Additional Actions to Improve the Timeliness of Collection Due Process Cases*, Reference # 2003-10-202, September 2003.

The (TIGTA) prepared a timeline of a typical CDP case and its milestones, based on a sample of 68 cases from a population of 4,895 CDP cases with determination dates from May 1 through August 12, 2002. In 60 of the 68 sample cases, or 88.2 percent, the total average period from receipt by Appeals to closure was 300 days.[36]

TABLE 1.4.2, SAMPLE CDP PROCESS TIMELINE

Type of Action	Date of Receipt	Number of Days
Case Received	Jan 2nd	0 days
Case Assigned to Hearing Officer	Jan 20th	18 days
Discussed or set hearing	Apr 16th	86 days
Determination Made	Jul 16th	91 days
Letter sent to Taxpayer	Aug 15th	30 days
Legal hold period	Sept 29th	45 days
Case Closed	Oct 29th	30 days
Totals	11 months	300 days

This timeline only partially identifies Appeals' timeliness problems in processing CDP cases. These figures do not include the time that the case can be held by field compliance prior to forwarding to Appeals.[37] Appeals has acknowledged that in many instances it takes up to 90 days for a case to be sent to Appeals thereby lengthening the timeline even further.[38]

Currently, the Appeals Quality Measurement System (AQMS) does not require a timeliness standard for contact with the taxpayer; it merely recommends that the officer make preliminary contact within 30 days of assignment.[39] At this time, the 30-day contact is not monitored. Appeals plans to introduce monitoring of the progress of the 30-day contact through on-going reviews by AQMS and annual operational reviews beginning in September 2004. This same monitoring was previously promised in a TIGTA report dated May 2001 for implementation in September 2001.[40]

[36] Treasury Inspector General for Tax Administration (TIGTA), *Appeals Could Take Additional Actions to Improve the Timeliness of Collection Due Process Cases*, Reference # 2003-10-202, September 2003.

[37] IRM 5.1.9.3.5(9). See discussion *infra*.

[38] Taxpayer Advocate Testimony At JCT Joint Review of IRS, Statement of Felice Izen, Supervisory Program Analyst, Office of Appeals, before the American Bar Association Low Income Taxpayers Committee, May 10, 2003, Tax Notes Today, 2003 TNT 98-32.

[39] Treasury Inspector General for Tax Administration (TIGTA), *Appeals Could Take Additional Actions to Improve the Timeliness of Collection Due Process Cases*, Reference # 2003-10-202, September 2003.

[40] Treasury Inspector General for Tax Administration (TIGTA), *Taxpayer Service on Lien and Levy Appeals Could Be Further Improved*, Reference # 2001-10-068, May 2001.

Appeals could set performance objectives or timeliness standards. The May 2001 TIGTA report cited:

> Appeals analysts and managers stated that they have been reluctant to establish time standards that might appear to impose goals that would conflict with IRS guidelines concerning the prohibition on production quotas. However, establishing a goal for timely contacting taxpayers and for continually working cases does not conflict with IRS guidelines.[41]

Timeliness standards ensure that cases receive prompt attention and move along at the proper pace. These standards also ensure that taxpayers are kept informed about the progress of their cases and the reasons for delay (including taxpayers' tardiness).[42]

Appeals customer satisfaction survey results indicate dissatisfaction with a delayed contact.[43] A recent TIGTA audit of Appeals' processing of CDP cases found that the earlier the taxpayer was contacted, the quicker the case was resolved.[44] TIGTA concluded that delays in contacting taxpayers occurred because Appeals had not established a specific time period within which hearing officers were required to discuss the case with taxpayers or schedule a hearing.[45]

IRS COMMENTS

The Advocate has raised four key issues to improve Collection Due Process in the IRS:

1. Many of the problems cited by critics of our current CDP program ". . . are largely the result of the IRS' failure to design and implement a program that delivers on Congress' promise of a meaningful hearing before the government. . ." takes enforcement action.

[41] Treasury Inspector General for Tax Administration (TIGTA), *Taxpayer Service on Lien and Levy Appeals Could be Further Improved*, Reference # 2001-10-068, May 2001. Sections 1204(a) and (b) of the IRS Restructuring and Reform Act of 1988, Pub.L. No. 105-206 specifically address production goals and employee evaluations. They require the IRS to not use records of tax enforcement results to evaluate employees or to impose or suggest production quotas or goals. Instead, the IRS must use the fair and equitable treatment of taxpayers by IRS employees as one of the standards for evaluating employee performance. These provisions would seem to support TIGTA's timeliness recommendation, rather than preclude them.

[42] For example, the Taxpayer Advocate Service measures quality by the timeliness of its employees meeting "next contact" dates with taxpayers and "follow up" dates with either the taxpayer or the IRS. While these measures are key to keeping cases moving and avoiding delays, they do not put pressure on the employee to resolve the case within a specific timeframe, since such pressure may result in issues being overlooked or superficial case resolution.

[43] Internal Revenue Service Customer Satisfaction Survey, *Appeals National Report*, covering October 2002 through March 2003, issued September 2003.

[44] Treasury Inspector General for Tax Administration (TIGTA), *Appeals Could Take Additional Actions to Improve the Timeliness of Collection Due Process Cases*, Reference # 2003-10-202, September 2003.

[45] Id.

2. IRS publications do not provide taxpayers with a clear, concise, plain English and in-depth discussion of Collection alternatives. The current publications only minimally meet our statutory obligation to inform the taxpayer about the CDP process.
3. Delays in forwarding CDP cases to Appeals while Compliance undertakes case resolution activities during the first 45 days after the request creates an additional burden for taxpayers and may undermine the taxpayer's rights to an Appeals hearing. The Advocate recommends within 15-30 days of the IRS' receipt of the timely request for CDP consideration Appeals issue its acknowledgement letter. This letter should state Appeals would grant a hearing within 30-45 days, and "that if the taxpayer wishes to continue negotiations with Compliance personnel, he should continue to do so." This recommendation further recommends where the taxpayer has not responded to the IRS ". . . Appeals should send a letter stating that the hearing would be scheduled within 60 days, and that a Compliance employee would contact the taxpayer to first attempt to resolve the matter at that level."
4. The CDP process takes too long and this is a direct result of the change in Appeals inventory since the enactment of the CDP statute in RRA '98. The Appeals Quality Measurement System does not require a timeliness standard for contact with the taxpayer, and only recommends the Appeals employee make preliminary contact within 30 days of assignment.

We agree with the fourth issue raised by the Advocate that the CDP process takes too long, and with her statement that this is a direct result of the change in Appeals inventory since the enactment of the CDP statute in RRA 98. Our discussion regarding the Advocate's most serious problem regarding "Appeals Inventory Delays" also addresses this concern.

We disagree with the first three issues raised and the Advocate's recommended process change. We also note the IRS has initiated close cross-functional coordination of all issues and concerns. Appeals, Counsel, SBSE and W&I Operating divisions regularly meet to discuss procedural and technical issues.

Concerning the first issue, we disagree with the Advocate's assertion that many of the problems cited by critics of our current CDP program ". . . are largely the result of the IRS' failure to design and implement a program that delivers on Congress' promise of a meaningful hearing before the government. . ." takes enforcement action. We believe the IRS has designed and implemented a process that delivers on Congress' promise of a meaningful hearing. This process complies with all of the statutory requirements by requiring Appeals to:

- verify proper procedures were followed
- consider all arguments and collection alternatives
- balance the Service's need to collect with the taxpayer's concern the proposed action is no more intrusive as necessary

The creation of the Collection Due Process case so dramatically changed our case receipts - from 14 percent Collection cases in FY 1997, none of which were CDP, to over 50 percent Collection cases in FY 2003, most of which are CDP - that all of our new technical hires since 2000 have been Collection personnel and the vast majority of our training has focused on Collection related issues since the passage of RRA 98.

In addition, the nature of our work has changed so fundamentally that it has caused us to begin the transformation of our organization from one exclusively field based to one where a significant portion of our technical resources will be located in a Campus environment.

The specific actions required of Appeals by RRA 98 are carefully enumerated in that statute. We are complying with the statute as written. The Advocate's suggestion that the Appeals review mandated by Congress should be expanded would require a legislative initiative to revise the provisions in the CDP statute.

Chief Counsel reviewed CDP cases proceeding to litigation and based on Chief Counsel and Justice Department records, found that very few appeals officer determinations in CDP cases have been overturned or conceded on appeal to the courts. Of the more than 38,000 CDP determinations issued during the fiscal years 1999, 2000, 2001 and 2002, only 35 determinations, or roughly one tenth of one percent, have been overturned or conceded on appeal. That represents just over three percent of the 1,085 cases disposed of by the courts. For this purpose, Chief Counsel counted as "losses" cases that were returned to the Office of Appeals because of a procedural error in the conduct of the CDP proceeding. In such cases the collection action may ultimately be sustained in further proceedings. In addition to cases involving errors in the CDP process, "losses" also include cases in which an error was detected in the assessment process, or in the underlying liability.

Chief Counsel has further informed us they are aware of only one case in which the Appeals Officer's judgment concerning the appropriateness of the collection action at issue, alone, was overturned. We believe these Chief Counsel findings show the statute has been properly implemented.

For additional support indicating the IRS has appropriately implemented the CDP provisions of RRA 98, we point to the annual statutory audit prepared by the Treasury Inspector General for Tax Administration. TIGTA is required to determine annually whether the IRS complied with the legal guidelines and required procedures for the filing of a notice of lien or a notice of intent to levy and the right of the taxpayer to appeal.[46] We believe the TIGTA reviews support that Appeals has successfully and properly implemented the CDP statutes.

The most recent mandatory CDP TIGTA audit of the conduct of Appeals CDP hearings (July 2003) found ". . .the Appeals Officers and Settlement Officers (hearing officers) were in compliance with the requirements of the law when conducting Collection Due Process (CDP) hearings and Equivalent Hearings (EH). The hearing officers appropriately verified that the IRS followed the applicable laws or administrative procedures during the lien and levy process. They considered the challenges the taxpayers raised and determined whether the proposed collection actions properly balanced the need for efficient collection of taxes with any legitimate taxpayer concerns. The hearing officers addressed these provisions in the CDP determination letters and the EH decision letters. In addition, the hearing officers followed guidelines from the Appeals manual by including information such as in which court the taxpayers must file their request for judicial review, as well as information about any agreements reached during the hearing, and any subsequent actions to be taken by the IRS or the taxpayer."[47]

TIGTA has made some recommendations to improve the CDP process, and we have taken all actions to implement them. The Advocate's report mentions a promise to monitor the 30-day contact guideline through the Appeals Quality Measurement System (AQMS). This has been done since January 2002. (See page 18 and footnote 41 for a reference to the report.) From the 2001 report, Appeals understood that the 30-day requirement was met by sending out an acknowledgement letter that described the Appeals process and gave a contact person.

However, TIGTA expanded its contact recommendation in the September 2003 report. Appeals agreed with the expansion of the 30-day requirement to include a mandate to make substantive contact within 30 days of assignment. Appeals is in the process of amending its AQMS review criteria to incorporate this TIGTA recommendation. We believe this change will assist in reducing the overall time for Appeals to resolve a CDP dispute – the Advocate's fourth issue. The current Appeals guidance to the field sets July 31, 2004 as the full implementation date of this expanded 30-day requirement. (Note: The September 2003 TIGTA audit was not a mandatory technical audit. It was an audit

[46] 26 U.S.C. §§ 7803(d)(l)(A)(iii) and (iv) (Supp. IV 1998).

[47] Quote taken from the last official mandatory CDP technical audit - Treasury Inspector General for Tax Administration, *Appeals Complied With the Legal Requirements for Collection Due Process and Equivalent Hearings*, Reference # 2003-10-156, July 2003.

initiated for the purpose of assisting Appeals in improving our time on CDP cases.)

Finally the Advocate believes that at least one part of the Appeals manual (IRM 8.7.2.3.10(8)(a)"...reflects Appeals' confusion about what exactly is the hearing officer's true role." We do not read our guidance in this same manner. The provision cited merely allows a hearing officer the latitude to correct obvious errors or raise collection alternatives the taxpayer obviously qualifies for regardless if raised by the taxpayer or not. This helps Appeals meet our obligation to balance the IRS's interest in collection of tax owed with the taxpayer's interest in having the proposed action be no more intrusive than necessary. This balancing requirement is part of the CDP statute.

Concerning the second issue, that IRS publications do not provide taxpayers with a clear, concise, plain English and in-depth discussion of Collection alternatives, we disagree with the Advocate. We agree with the Advocate that the IRS and Appeals must constantly review and revise its information and publications.

In January 2003 the Internal Revenue Service revised its main publication concerning collection options, What You Should Know About The IRS Collection Process, Publication 594. This publication describes in detail the Collection Process. It lists seven specific issues a taxpayer may want to discuss with Appeals, one of which is "collection options." These "collection options" are then described to the taxpayer.

Appeals identifies the collection alternatives in a number of its own publications. Some of the publications and/or letters include:

- Publication 1660, Collection Appeal Rights, Revised May 2002 (mailed by Compliance)
- Publication 4165, An Introduction to Collection Due Process Hearings, Revised September 2003
- Form 13221, acknowledgement letter
- Letter 3544, information request (Mailed by Appeals with attachment identifying documents required for each Collection alternative)

Compliance mails Publication 1660 to the taxpayer with the CDP notice after they file a lien or before they levy. Appeals mails Publication 4165 with the acknowledgement letter to the taxpayer and provides a contact person. While we will always review and improve the publications, we believe these publications are very successful at identifying the collection alternatives.

The IRS Chief Counsel determined that Publication 594 and Publication 1660 meet the disclosure requirements set by IRC 6330. These publications, sent with each CDP notice, fully and carefully discuss the CDP issues including collection alternatives. In addition, the main collection alternatives of installment agreements, offer-in-compromise, and a temporary delay in the collection process are also discussed in Publication 3498, The Examination Process. Publication 3498 is provided to taxpayers where the dispute results from an IRS initiated review of the taxpayer's filed return. This publication informs taxpayers of their right to an appeal of the examination and their payment options.

In addition, Appeals has already drafted a new initial contact letter (sent to the taxpayer after it initially acknowledges receipt of the case). In that draft letter, currently in clearance with the Advocate, Chief Counsel and Compliance, the Appeals employee identifies that they will consider (in part) relevant issues the taxpayer wishes to discuss including collection alternatives.

Concerning the third issue, we disagree that delays in forwarding CDP cases to Appeals while Compliance undertakes case resolution activities during the first 45 days after the request creates an additional burden for taxpayers or undermines the taxpayer's rights to an Appeals hearing. The Advocate recommends that within 15-30 days of the IRS' receipt of the timely request for CDP consideration that Appeals issue its acknowledgement letter. This letter should state Appeals will grant a hearing within 30-45 days, and "that if the taxpayer wishes to continue negotiations with Compliance personnel, he should continue to do so." This recommendation further recommends that where the taxpayer has not responded to the IRS "..., Appeals should send a letter stating that the hearing would be scheduled within 60 days and that a Compliance employee would contact the taxpayer to first attempt to resolve the matter at that level". We disagree with these recommendations as well.

The process recommended by the Advocate will not have the desired effect of clarifying to taxpayers that their case will be considered by Appeals. Compliance procedures already address the Advocate's concerns. Compliance employees retaining jurisdiction of a particular case must reach mutual agreement with the taxpayer that there is an opportunity to resolve the dispute at that level. Usually this means explaining the collection alternatives to the taxpayer, securing required forms for those alternatives, and securing IRS approval for the alternatives.

The recommended process may only further confuse the taxpayers as to the jurisdiction of their case. It would find the case transferred from Compliance to Appeals for the issuance of an acknowledgement letter only to have the case transferred to Compliance for case resolution discussions at the lowest possible level. This recommended action could only result in further delays in meaningful case consideration by either Compliance or Appeals and not in eliminating delays in scheduling and holding hearings.

Since the authorities Appeals has on Collection matters are generally no greater than those provided to Compliance, holding the case an additional 45 days clearly does not deny a taxpayer a particular collection alternative. It merely affords them an opportunity to resolve the dispute at the earliest possible level.

It is the view of both Appeals and Compliance that the proposed solution to have Appeals send out a letter giving the taxpayer additional time to work with Collection would not work as well as the current process. We believe this to be true for several reasons:

- The Advocate's proposal would give all taxpayers the opportunity for an additional 30-60 days, depending on their prior response to their request for a due process appeal. The current process gives the additional time only to those cases upon which Compliance believes resolution can be reached.
- Some taxpayers clearly state on their hearing request the resolution that they are seeking, i.e., installment agreement or hardship. Compliance can explain the requirements to the taxpayer and address the concern more quickly under the current process than if they are required to wait for Appeals to send a letter.
- Many taxpayers do not make the clear distinction between an Appeals organization and a Compliance organization that we in the Service do. The actions Compliance takes during the 45 days are limited to initiating case resolution alternatives requested by the taxpayer.
- In some instances, Compliance may have to contact the taxpayer for clarification regarding the hearing request. If Compliance is working with the taxpayer to clarify other issues, it is simpler to address all the issues rather than wait for Appeals to send a letter.

Note that this "45 Day" process is addressed in the regulations:

> Q-C9. Can taxpayers attempt to resolve the matter of the proposed levy with an officer or employee of the IRS office collecting the tax liability stated on the CDP Notice either before or after requesting a CDP hearing?
>
> A-C9. Yes. Taxpayers are encouraged to discuss their concerns with the IRS office

> collecting the tax, either before or after they request a CDP hearing. If such a discussion occurs before a request is made for a CDP hearing, the matter may be resolved without the need for Appeals consideration. However, these discussions do not suspend the running of the 30-day period within which the taxpayer is required to request a CDP hearing, nor do they extend that 30-day period. If discussions occur after the request for a CDP hearing is filed and the taxpayer resolves the matter with the IRS office collecting the tax, the taxpayer may withdraw in writing the request that a CDP hearing be conducted by Appeals.

This process was created by a cross-functional group of Appeals, Counsel, Small Business/Self Employed and Wage and Investment in an effort to allow taxpayers to resolve collection disputes at the lowest possible level with the least amount of delay. If at any time a taxpayer wishes to curtail its contact with the Compliance functions, they may do so and the IRS will transfer the case immediately to Appeals.

The current process has proven successful. Compliance indicates they secure agreement on 10 percent to 12 percent of the cases (closed via CDP withdrawal). For FY 03 this volume is estimated to be approximately 3,500 cases resolved/withdrawals secured without having to go to Appeals. These numbers do not include other cases, which Compliance has resolved, but the taxpayer did not withdraw the hearing request. The Appeals work on these cases is significantly limited as a result, freeing Appeals employees to work on truly unresolved issues and cases.

We also note that Compliance procedures already require their employees to explain to taxpayers that they will receive an immediate Appeals hearing if they desire it and the Compliance employee is only offering assistance in resolving the dispute. See IRM 5.1.9.3.5(4). Continuing to work with the taxpayer allows Compliance to review new information regarding the collection alternatives not previously considered. If after 45 days from receipt of the CDP hearing request, resolution of the taxpayer's issues seems likely Compliance will secure group manager concurrence to continue working with the taxpayer. We believe this managerial involvement protects the taxpayer from a case being retained unnecessarily in Compliance.

Regarding the fourth issue, the Taxpayer Advocate believes the CDP process takes too long and this is a direct result of the change in Appeals inventory since the enactment of the CDP statute in RRA 98, we agree and this is a concern of ours as well.

The Taxpayer Advocate correctly cites the latest completed CDP TIGTA audit findings. Appeals has embraced the recommendation that a substantive contact within 30 days of assignment of a CDP case could significantly reduce the cycle time from date received to date notice of determination issued to the taxpayer from 225 days to 169 days. We will make further inroads into reducing cycle time by assigning the cases faster, segmenting the assignment and standardizing the work, and making other improvements in the case consideration process. (Note: TIGTA identified the entire process being 300 days; however, the final 75 days are for legal holding period requirements and necessary processing time where judicial review is not requested. The taxpayer is fully informed of the determination on average in 225 days in the TIGTA study.)

The Advocate correctly indicates the case may be delayed up to on average an additional 90 days when the case is held in Compliance prior to forwarding it to Appeals. As previously stated, this period is only when there is agreement between the taxpayer and Compliance that the case could potentially be expeditiously resolved at this lower level.

Regarding the Advocate's concerns that the Appeals Quality Measurement System does not require timeliness standard for contact, we need to clarify our actions. The recommendation from the May 2001 TIGTA report pertinent to this discussion was: "Appeals should establish timeliness standards for making first contacts with taxpayer and working CDP cases and include these measures in the closed case quality review program."

At the time Appeals did not agree that we could adopt that exact recommendation. Instead, Appeals agreed to: "1. Send an acknowledgment letter to taxpayers for CDP cases within 30 days. (These letters will include the name of a contact person, and a description of the process.); and, 2. Provide on-going review and feedback by establishing Appeals Quality Measurement System (AQMS) guidelines specific to Collection Due Process cases. This will include the 30-day contact letter requirement."

Therefore we do not agree with the Advocate's statement that we previously promised, in the May 2001 TIGTA report, to make substantive contact within 30 days and would monitor this in AQMS. However, we have been in compliance with our agreed to actions since January 2002.

When this issue was raised again in the September 2003 report, we agreed to revise the Appeals IRM and the AQMS instructions to require that Appeals should make a significant contact with a CDP taxpayer within 30 days to discuss the taxpayer's case or to schedule a future conference date. Because our ability to reach this goal was related to successful implementation of our campus Appeals operations, we stated we needed a 1-year period to successfully fully implement the recommendation. Full implementation of this recommendation is expected by July 31, 2004.

We also note Appeals is currently redrafting its AQMS guidelines regarding prompt assignment and acknowledgement of cases in Appeals. AQMS is currently in the process of revising both its review sheet and instructions and revision of the IRM is in process. Appeals is incorporating the 30-day substantial contact in the new guidelines.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate is pleased that Appeals is beginning to address some of the timeliness issues associated with the Collection Due Process program. She continues to be concerned about the manner in which the Office of Appeals is administering the CDP program. She finds Appeals' comments largely unresponsive to many of the concerns she has raised about the program.

Appeals states that it is complying with the CDP statute as written. It further states that any "expanded" review by Appeals would have to require a specific legislative mandate.

The National Taxpayer Advocate agrees that Appeals is complying, albeit narrowly, with the technical language of the statute with regard to findings it must make in any hearing. Appeals' analysis should not stop there, however. In IRC sections 6320 and 6330, Congress created an informal adjudication procedure for contesting IRS collection actions. Such informal adjudications must meet basic administrative requirements of due process under the Administrative Procedure Act. Further, the procedures must satisfy whatever specific technical requirements Congress imposes. But nothing in the statute prohibits Appeals from implementing the recommendations of the National Taxpayer Advocate with regard to CDP procedures, including revising notices and educational materials.

Appeals cites the low rate of reversal in CDP litigation as an indication that it is effectively implementing the CDP program. The legislative history indicates that Appeals' determinations with respect to collection issues are subject to an "abuse of discretion" standard of review by the courts. This standard presents a very high hurdle for any taxpayer to meet in order to obtain a reversal. In fact, the use of this standard reinforces the importance that the CDP program be properly administered, both in conformity with the spirit as well as the letter of the law.

A far better measure of Appeals' successful implementation of the CDP program would be derived from tracking CDP cases to see whether Appeals' recommendations did, in fact, resolve the taxpayer's collection issues with the IRS. Did the taxpayer continue to make payments on an installment agreement, or did he default and continue to require compliance's attention? Would an offer-in-compromise have been a better resolution of the matter? To our knowledge, neither Appeals nor Compliance is tracking such information.

Appeals states that there are numerous IRS and Appeals' publications that describe the various collection alternatives available to a taxpayer. Interestingly, the one that contains the most detailed (but not coherent) descriptions, Publication 3498, The Examination Process, is not included in any collection notice associated with the CDP hearing process.[48]

The National Taxpayer Advocate reiterates her position that without clear and understandable explanations of the available collection alternatives, a taxpayer will not be able to meaningfully enter into a discussion with the hearing officer about his or her situation. She has proposed several possible methods of communicating this information to taxpayers in the context of the Collection Due Process program, and she believes that her proposals will create a better record upon which both the hearing officer and the court can rule.

In its response to the National Taxpayer Advocate's concerns about the jurisdiction of CDP cases, Appeals fails to address her fundamental point that CDP is something different from "business as usual" in the IRS Compliance function. Appeals states that the CDP process was developed by a cross-functional group of Appeals, Counsel, SB/SE and W&I in "an effort to allow taxpayers to resolve collection disputes at the lowest possible level with the least amount of delay." Yet, taxpayers already had that option available to them prior to RRA 98!

The Collection Due Process program reflects Congress' considered judgment that taxpayers required something more than the ability to resolve collection disputes at the lowest level. Nothing in Appeals' response indicates that it cannot design processes that would enable a case to be resolved appropriately by Compliance while ensuring that Appeals is, in fact, the immediate and ultimate "owner" of the case.

Finally, Appeals states that "many taxpayers do not make the clear distinction between an Appeals organization and a Compliance organization that we in the Service do." That is precisely the National Taxpayer Advocate's point: taxpayers do not know that Appeals exists and that, as a CDP hearing officer, it plays a different role from that of Compliance. Without knowing about this significant difference, how can taxpayers truly make an informed decision about electing CDP procedures?

[48] The National Taxpayer Advocate notes that Publication 3498 is in the process of being revised to address some of her concerns about its lack of clarity.

The National Taxpayer Advocate will continue to work with the Office of Chief Counsel, and the Office of Appeals, to address the serious concerns and thoughtful recommendations presented above. The proper implementation of the Collection Due Process program is all the more important in the current environment of increasing collection activity.

PROBLEM
TOPIC #5

MOST SERIOUS PROBLEM: INDIVIDUAL TAXPAYER IDENTIFICATION NUMBER (ITIN) PROGRAM & APPLICATION PROCESS

IRS RESPONSIBLE OFFICIALS

Henry O. Lamar, Commissioner, Wage & Investment Division
Jerald H. Heschel, Director, ITIN Program

DEFINITION OF PROBLEM

The Internal Revenue Service issues Individual Taxpayer Identification Numbers (ITINs) to individuals who are not eligible to receive Social Security numbers (SSNs) and yet need an identification number for tax administration purposes.[1] While the IRS frequently exceeds its own four to six week timeframe for processing ITIN applications,[2] demand for ITINs is increasing as a result of demographic changes in the U.S. population.[3] At the same time, some states and advocacy groups view the ITIN as a number that can be used for identification purposes and as an important tool for banking the unbanked in our society; others believe that the IRS should share ITIN information routinely with other government agencies, including the Bureau of Citizenship and Immigration Services.[4] These competing pressures threaten to undermine sound tax administration practices.

ANALYSIS OF PROBLEM

Background

A 1994 study identified significant tax compliance problems with the 80 billion dollar annual investment income of nonresident aliens.[5] In response to these findings, the IRS created Individual Taxpayer Identification Numbers (ITINs) in 1996. These numbers resemble SSNs but begin with the number 9 (e.g., 9xx-xx-xxxx). They are used by non-U.S. citizens who are not eligible to receive Social Security numbers (SSNs) yet have U.S. tax obligations.[6] The ITIN was created so these individuals could file tax returns and the IRS could appropriately match the return data with reported dividend, interest, and other income.[7]

[1] Treas. Reg. § 301.6109-1(d)(3).

[2] Latin Americans For Social Economic Development/Accounting Aid Society, Detroit; Midwest Tax Clinic Center for Economic Progress, Chicago; and First Commercial Bank, Oklahoma, May 2003.

[3] Urban Institute, "*The Dispersal of Immigrants in the 1990s*," November 26, 2002, available at http://www.urban.org.

[4] On March 1, 2003, the responsibility for providing immigration-related services and benefits such as naturalization and work authorization was transferred from the Immigration and Naturalization Service (INS) to the Bureau of Citizenship and Immigration Services (BCIS) in the Department of Homeland Security. Source: DHS website, available at http://www.dhs.gov.

[5] Treasury Inspector General for Tax Administration, *The Internal Revenue Service's Individual Taxpayer Identification Number Program Was Not Implemented in Accordance with Internal Revenue Code Regulations*, Reference Number 094505, September 1999, p. 3.

[6] IRC § 6109 and Treas. Reg. § 301.6109-1(d)(3).

[7] Treasury Inspector General for Tax Administration, *The Internal Revenue Service's Individual Taxpayer Identification Number Program Was Not Implemented in Accordance with Internal Revenue Code Regulations*, Reference # 094505, September 1999, p. 7.

Under the Internal Revenue laws, a taxpayer's immigration status alone is not determinative of a person's status as a U.S. taxpayer. "Resident aliens" – that is, alien taxpayers who are either permanent resident aliens under U.S. immigration law or who meet a "substantial presence" test – are taxed on their worldwide income, subject to applicable treaty provisions.[8] "Nonresident aliens" - alien taxpayers who do not meet either the "permanent resident" or the "substantial presence" test - are taxed at a flat 30 percent rate on their U.S. source income and foreign source income that is effectively connected with the conduct of a trade or business within the U.S.[9]

Thus, regardless of immigration status, taxpayers who are considered either resident or nonresident aliens under the Internal Revenue laws have a need for identifying numbers for federal tax administration purposes. As the tax administrator, the IRS is charged with developing a program that enables these taxpayers to comply with their U.S. tax obligations. Regardless of immigration status or country of origin or residence, an efficient and equitable tax system does not distinguish between alien and other taxpayers with respect to levels of taxpayer protections or customer service.

As noted above, ITINs are available to resident and nonresident aliens, their spouses, and their dependents who are not eligible to receive SSNs and who have a need for a number for federal tax administration purposes. An ITIN does not authorize an alien to work in the United States, grant an immigration status, or qualify the alien for benefits, such as the Earned Income Tax Credit (EITC) and Social Security.[10] To receive an ITIN, individuals must complete Form W-7, Application for the IRS Individual Taxpayer Identification Number, and attach documentation validating his or her identity and foreign alien status.[11] All Form W-7 applications are processed at IRS's Philadelphia campus.

ITIN USAGE AND DEMOGRAPHICS

Since the ITIN program's inception in 1996, the demand for ITINs has increased, consistent with the change in the nation's immigrant population. Further, the reasons given by individuals applying for ITINs and the subsequent actual usage of ITINs on tax returns demonstrate a legitimate tax administration need for these numbers.

The use of ITINs continues to grow as the immigrant segment of the U.S. population becomes a substantial and increasing presence in our economy. Over one million immi-

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[8] IRC sec 7701(b); Treas. Reg. 301.7701(b)-1.

[9] IRC sec 871; 864(c)(1)-(4).

[10] IRS, *Understanding Your IRS Individual Taxpayer Identification Number*, Publication 1915 (Revision 11-2002), p. 1. When a taxpayer reports Social Security earnings and taxes under an ITIN, the Social Security Administration (SSA) will place those taxes in a "suspense account" because the ITIN does not match a Social Security Number. If the taxpayer later becomes eligible for a SSN, however, he can ask the SSA to reallocate the ITIN earnings and taxes to his SSN account.

[11] IRS, *Understanding Your IRS Individual Taxpayer Identification Number,* Publication 1915 (Revision 11-2002), p. 8.

grants entered the United States each year during the 1990s.[12] Table 1.5.1 depicts the increase of foreign born/immigrant individuals in the United States.[13]

TABLE 1.5.1 FOREIGN BORN/IMMIGRANT POPULATION AND TOTAL POPULATION FOR THE UNITED STATES (IN MILLIONS): 1850 TO 2000

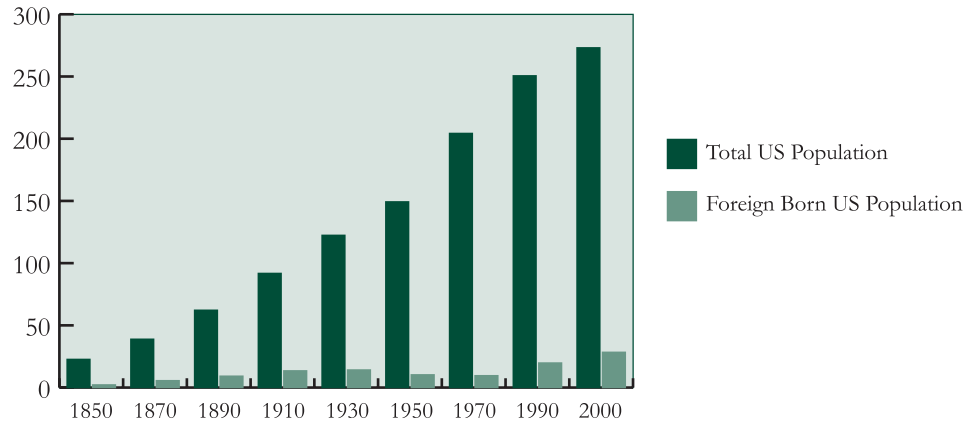

TABLE 1.5.2, POPULATION PERCENTAGES

Year	Total US Population	Foreign Born US Population	Foreign Born Percent of Total Population
1850	22.7	2.2	9.7
1870	38.9	5.6	14.4
1890	62.2	9.2	14.8
1910	91.8	13.5	14.7
1930	122.4	14.2	11.6
1950	149.3	10.3	6.9
1970	204.3	9.6	4.7
1990	250.6	19.8	7.9
2000	**273.1**	**28.4**	**10.4**

[12] Urban Institute, *The Dispersal of Immigrants in the 1990s*, November 26, 2002, available at http://www.urban.org.

[13] U.S. Census Bureau, "Coming To America: A Profile of the Nation's Foreign-Born (2000 Update), February 2002.

As of March 2000, according to data collected in the Current Population Survey, the estimated foreign born population of the United States was 28.4 million. The preceding table and chart show an increase in the total U.S. population that is foreign born (or immigrated to the US). The data collected in 2000 indicated that 10 percent of the U.S. population was foreign born, the highest percentage since 1930.

By 2010, the U.S. foreign born or immigrant population is expected to increase to approximately 34 million.[14] These individuals are transforming the U.S. workplace. Over the past decade, immigrants (with or without authorization to work in the U.S.) accounted for half of the new wage earners entering the labor force.[15] As immigrants enter the U.S. workforce, either on temporary work visas or as undocumented workers, they incur U.S. tax obligations with a corresponding increase in the demand for ITINs. In calendar year 2002, the total number of ITINs issued was 1.5 million, an increase from 0.6 million issued in calendar year 1999. Table 1.5.3 shows ITIN issuance since 1996, the first year of the program.

TABLE 1.5.3, ITINS ISSUED SINCE 1996[16]

Calendar Year	1996	1997	1998	1999	2000	2001	2002	2003
ITINS (Assigned, in millions)	0.1	1.4	0.6	0.6	0.8	1.1	1.5	0.9

In a study conducted for the Commissioner, the IRS Information Technical Service identified the reasons why applicants requested ITINs and how the numbers were eventually used. Table 1.5.4 shows the reasons listed on Forms W-7 for ITINs issued for calendar years 1996 through 2002 (partial year for 2003, includes January 1 through September 30).[17]

[14] U.S. Census Bureau Projections, available at http://www.census.gov. See also, Ciyata D. Coleman, *Demographic and Economic Characteristics of the American Family: Implications for Outreach Targeted at the Low-Income Population*, IRS Research Conference, June 2003, p. 3, Figure 1: Population By Age Group 2000-2010.

[15] Kay Anderson, *W&I Taxpayer of the Future*, 2003 IRS Research Conference (June 2003) p. 7.

[16] IRS Individual Master File, Returns Transaction File, Analysis conducted by MITS, Information Technical Services, Business Systems Development, Business Systems and Extracts, Calendar Years 1996 - 2003 (2003 information is for a partial year - includes January 1 - September 30, 2003).

[17] This version of Form W-7, Application for IRS Individual Taxpayer Identification Number (Rev. October 1999), gave the applicant a choice of six reasons for applying for an ITIN. The current form (revised in December 2002) gives the applicant eight possible reasons for applying.

TABLE 1.5.4, REASONS FOR SEEKING ITINS (TAX YEARS 1996- 2003)[18]

Reason	1	2	3	4	5	6	
Calendar Year	Nonresident treaty	Nonresident return	U.S. Resident	Dependent of	Spouse of	Other	Total
1996	17.2%	42.6%	23.8%	7.8%	8.5%	0.1%	100%
1997	25.8%	27.6%	26.2%	12.7%	7.5%	0.1%	100 %
1998	1.9%	23.5%	21.6%	32.3%	13.2%	7.5%	100%
1999	4.1%	21.2%	26.6%	29.4%	11.4%	7.3%	100 %
2000	5.0%	23.8%	27.1%	26.3%	10.2%	7.5%	100%
2001	5.1%	22.0%	31.2%	23.5%	9.0%	9.2%	100 %
2002	4.9%	22.6%	36.2%	19.7%	6.4%	10.2%	100 %
Total	**9.4%**	**23.9%**	**29.3%**	**21.8%**	**8.8%**	**6.7%**	**100%**

The top three reasons for seeking ITINs were:

- U.S. resident alien (based on days present in the U.S.) filing a U.S. tax return and not eligible for an SSN;
- Dependent of U.S. person; and
- Nonresident alien filing a U.S. tax return and not eligible for an SSN.

These reasons accounted for approximately 75 percent of all ITIN applications.[19] A similar report requested by the National Taxpayer Advocate identified the country of origin of ITIN applicants. The applications came from all 50 states and the District of Columbia, but most were concentrated in 11 states. Table 1.5.5 shows the percentage of applications for these states for calendar years 1999 through 2001.[20]

[18] IRS Individual Master File, Returns Transaction File, Analysis conducted by MITS, Information Technical Services, Business Systems Development, Business Systems and Extracts, Calendar Years 1996 - 2003 (2003 information is for a partial year - includes January 1 - September 30, 2003).

[19] Id.

[20] ITIN Applicant Profile, Project 4-03-09-2-040N, Interim Report dated September 11, 2003, page 4.

TABLE 1.5.5, ITIN APPLICATIONS BY STATE (CALENDAR YEARS 1999-2001)

Arizona	2.2%	2.7%	2.1%
California	28.5%	27.4%	27.1%
Colorado	1.4%	2.1%	1.8%
Florida	4.3%	5.1%	4.9%
Georgia	2.9%	3.2%	3.3%
Illinois	4.1%	4.7%	4.3%
New Jersey	3.4%	3.8%	3.5%
New York	6.9%	7.2%	7.3%
North Carolina	3.2%	4.3%	3.4%
Texas	10.7%	10.2%	10.4%
Utah	5.2%	2.4%	3.4%
Total	**72.8%**	**73.1%**	**71.5%**

While the applicants were citizens of many countries, a handful of nations accounted for the majority of applicants. Table 1.5.6 lists the percentage of ITIN applicants from countries that provided at least one percent of the applicants in one of the three years. These 17 countries accounted for at least 85 percent of all applicants for the three tax years. Mexico was by far the largest source of ITIN applicants, with over 53 percent of the applicants in each year. No other country provided more than five percent of the applicants in any one year.[21]

[21] ITIN Applicant Profile, Project 4-03-09-2-040N, Interim Report, September 11, 2003, Wage & Investment Research Group 4, W-7 ITIN Database.

TABLE 1.5.6, ITIN APPLICANT COUNTRIES OF ORIGIN (CALENDAR YEARS)

Country	CY 1999	CY 2000	CY 2001
Asia			
China	2.2%	2.1%	1.9%
India	3.7%	3.7%	3.4%
Japan	1.8%	1.5%	1.2%
South Korea	0.8%	1.0%	1.0%
Philippines	1.1%	1.1%	1.3%
Latin America			
Argentina	0.4%	0.5%	1.0%
Brazil	2.4%	2.5%	2.1%
Colombia	1.6%	2.6%	3.0%
Ecuador	1.2%	1.4%	1.6%
El Salvador	1.9%	1.9%	1.7%
Grenada	1.5%	1.5%	1.6%
Honduras	0.7%	0.9%	1.3%
Mexico	56.6%	53.6%	56.6%
Peru	0.8%	1.0%	1.5%
Europe			
Germany	2.6%	4.9%	2.8%
United Kingdom	1.9%	1.7%	1.5%
Other			
Canada	4.6%	3.8%	3.4%
Total	**85.8%**	**85.7%**	**86.9%**

The IRS has issued approximately 6.9 million ITINs since the program's inception in 1996 (as of October 1, 2003).[22] Nearly three-quarters of the ITINs issued with the expecta-

[22] IRS Individual Master File, Returns Transaction File, Analysis conducted by MITS, Information Technical Services, Business Systems Development, Business Systems and Extracts, Calendar Years 1996 - 2003 (2003 information is for a partial year - includes January 1 - September 30, 2003).

Of the 6.9 million ITINs issued, IRS expected approximately 5.7 million to show up on tax returns. The expected usage is calculated as follows:

6,926,446 (ITINs assigned as of 10/01/03) - [23,969 (ITINs issued in 96 cannot be accounted for, as 96 and 97 return data is not available) + 540,801 (ITINs issued in 97 cannot be accounted for as 96 and 97 return data is not available) + 636,013 (ITINs issued in 03 could be used on 03 returns filed in 04)] = 5,724,663 (ITINs expected to be used on 98,99,00,01,02 returns).

4,269,484 ITINs on 98-02 returns/5,724,663 expected on returns = 74.58 percent.

tion that they would be used for tax filing purposes actually showed up on returns. This illustrates that the ITIN population is a very compliant sector of the U.S. taxpayer population.

TABLE 1.5.7, ITIN ISSUANCE AND USAGE (CALENDAR YEARS 1998 - 2001)[23]

Year	Assigned	Used on Tax Return	% Used
1998	566,745	403,517	71.2%
1999	615,413	469,657	76.3%
2000	818,392	612,108	74.8%
2001	1,088,837	748,398	68.7%
Total	**3,089,387**	**2,233,680**	**72.3%**

Although tax return filing is clearly the primary tax administration purpose for issuing ITINs, there are others. For example, an ITIN could be issued for a non-interest bearing financial account in order to identify possible levy sources in the event that IRS must take collection actions. Moreover, some ITINs may be issued to taxpayers who are working and anticipate a filing obligation, but who ultimately earn so little that they are not required to file a return.

Individual Taxpayer Identification Numbers are often issued for a specific purpose involving limited or one-time use. For example, immigrants often obtain ITINs for tax returns, in order to demonstrate good moral character for purposes of adjusting their immigration status.[24] Once their status is adjusted, they may be able to obtain SSNs. Further, ITINs issued to persons employed in the U.S. on temporary work visas do not expire after the worker returns to his or her home country. Foreign investors may need the number for a one-time transaction and not use the number again, or only sporadically. The IRS does not presently "sunset" or set an expiration date for ITINs.

23 Individual Master File, Returns Transaction File, Analysis conducted by MITS, Information Technical Services, Business Systems Development, Business Systems and Extracts, Calendar Years 1998 - 2001. Since data is unavailable to validate 1996 and 1997, and ITINs obtained in 2003 may take several years to show up on a tax return, we will report information on ITIN usage for 1998- 2001. Of the approximately 2.2 million distinctive ITINs that were included on tax returns for Tax Years 1998 - 2001, about 40 percent were used by a primary filer, 25 percent by a secondary filer, and about 33 percent were used to identify dependents.

24 Since Congress combined and receded all previous immigration and naturalization law into the Immigration and Nationality Act of 1952, the United States has conducted only one immigrant amnesty program, authorized by the Immigration Reform and Control Act of 1986 (Source: Marian L. Smith, Overview of INS History, U.S. Citizenship and Immigration Services). Taxpayers in these programs would no longer need an ITIN since they are eligible to receive an SSN. The IRS could easily obtain information about ITIN obsolescence without exchanging information with other government agencies. The IRS could design a form that is provided to the taxpayer by the immigration or social security agencies at the time of application, but is sent directly to the IRS, notifying the IRS that the ITIN should be retired.

Communication Strategy and Assistance

The IRS must improve ITIN assistance and communications to ensure the numbers are used properly and that applicants are able to comply with the tax laws. The IRS acknowledged in its "Compliance 2000" report that "alien populations face distinctive challenges in attempting to meet their tax responsibilities."[25] Foreign born or immigrant taxpayers, regardless of immigration status, face language and cultural barriers. Many immigrants come from countries in which the tax system does not function well (if at all), or assesses and collects tax without a filing requirement. Undocumented immigrant workers may be wary of approaching the tax administrator, particularly those whose countries of origin had governments that were instruments of oppression.

When immigrants attempt to meet their tax obligations, they may not be able to navigate the tax system or be able to explain their situation properly. Because they may not yet have entered the mainstream of the U.S. economy, they may not be able to find qualified professional assistance and instead are "helped" by persons who are unqualified if not unscrupulous. Finally, taxpayers may be afraid to file because the failure to file earlier tax returns will result in penalties and interest that often amount to more than the immigrant's annual income.

This situation is best remedied by proactive interventions that encourage new immigrants to comply with U.S. tax laws from the date of their arrival in the United States, regardless of immigration status.[26] The IRS must make significant efforts to include these individuals in the tax system and not increase burden or create barriers. For example, at the urging of the National Taxpayer Advocate, the IRS revised and simplified the Spanish version of the form W-7 for the 2003 filing season.[27]

Acceptance Agents,[28] practitioners, and volunteers report that the IRS does not provide them timely and quality information about helping individuals secure ITINs.[29] For the 2003 filing season, the IRS issued two news releases that advised individuals to use the revised Form W-7, and mailed Information Alerts to Acceptance Agents.[30] The alert

[25] IRS research project, *Compliance 2000 Immigrant Prototype*, 1994, p. 5.

[26] Id.

[27] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 92.

[28] An Acceptance Agent facilitates the ITIN application process by obtaining and reviewing the required forms and documentation. Certified Acceptance Agents can certify to the IRS that the documents are authentic, complete and accurate and forward only the certification and W-7 form to the IRS. The certifying agent is required to maintain a record of the documentation for a definite period of time. The certifying agent must agree to submit supporting documents to IRS upon written request. Revenue Procedure 96-52, 1996 C.B. 372.

[29] Treasury Inspector General for Tax Administration, *The Internal Revenue Service's Individual Taxpayer Identification Number Program Was Not Implemented in Accordance with Internal Revenue Code Regulations,* Reference # 094-505, September 1999, p.10.

[30] IRS News Release IR-2002-139, December 17, 2002; IRS News Release IR2003-49, April 10, 2003, "ITIN Applicants Must Use New Form Starting April 14;" Acceptance Agent Information Alert, March 17, 2003, "IRS Makes Major Changes to Forms W-7 & W-7(SP), Application for Individual Taxpayer Identification Number (ITIN): Submission Cut-off Dates Key to Timely Processing."

advised that the new form had enhancements, including more stringent documentation criteria, but did not outline the exact changes. These communications were not distributed soon enough for agents to tell their customers about the changes before the end of the filing season. An IRS report on the ITIN program validates the concerns of the agents. The report states, "There is no coordinated Service-wide strategy to effectively promote, market, and disseminate ITIN program and processing information to external stakeholders."[31]

Congress explicitly recognized the special needs of taxpayers who speak English as a second language (ESL) in entering and navigating the U.S. tax system in the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).[32] Internal Revenue Code section 7526 authorizes matching grants to low income taxpayer clinics that provide tax education and outreach to ESL taxpayers as well as *pro bono* or nominal fee representation to low income taxpayers (including ESL) in tax controversies.[33] The Low Income Taxpayer Clinic (LITC) grant program was enacted following testimony before the National Commission on Restructuring the Internal Revenue Service and both houses of Congress.[34] The legislation makes no distinction about a taxpayer's immigration status as eligibility criteria for LITC assistance. Low Income Taxpayer Clinics have testified before Congress about their activities, including those addressing tax problems of documented and undocumented immigrant taxpayers.[35] Clinics and Volunteer Income Tax Assistance (VITA) programs play a vital role in distributing information about tax duties and rights to foreign born and immigrant taxpayers.

Processing Delays and Problems

Taxpayers requesting ITINs experience hardships when ITIN processing is delayed. ITIN applicants are subject to the same filing requirements and potential penalties as taxpayers using SSNs. ITIN application processing may be delayed from six to eight weeks to 10 weeks or longer. The ITIN processing delay can in turn delay return processing, and can inadvertently lead to the disallowance of credits for dependents.[36]

[31] Internal Revenue Service, *Individual Taxpayer Identification Number (ITIN), National Task Force, Final Report,* September 11, 2002, p.12.

[32] Pub. L. No. 105-206 at 1171.

[33] As of the 2004 grant cycle, there are approximately 135 Low Income Taxpayer Clinics, with a clinic in all but one state. Some clinics provide ESL outreach and education, and others provide both controversy representation and ESL outreach and education. For more information about the LITC program, see http://www.irs.gov/advocate/index.html.

[34] Hearing on the Recommendations of the National Commission on Restructuring the IRS on Taxpayer Protections and Rights, Subcommittee on Oversight of the House Committee on Ways and Means, 105th Cong., 2nd Sess., September 26, 1997 (Testimony of Nina E. Olson, Executive Director, The Community Tax Law Project, Richmond, VA).

[35] Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means, Hearing on the Taxpayer Advocate Report and the Low-Income Taxpayer Clinic Program, 107th Congress, 2nd Sess., July 12, 2001.

[36] Interviews with Latin Americans For Social Economic Development/Accounting Aid Society, Detroit; Midwest Tax Clinic, Center for Economic Progress, Chicago; and First Commercial Bank, Oklahoma, May 2003.

The IRS has acknowledged that it does not have adequate staff to handle both Form 1040 returns and Form W-7 applications in a timely manner during the filing season, and that application submissions are cyclical.[37] Form 1040 processing takes priority until filing season ends, usually on June 1 of each year.[38] As of September 2003, 69 percent (848,627) of applicants who submitted Forms W-7 in 2003 had received ITINs, while approximately five percent (63,503) of the applications were held, suspended or not worked.[39] The rest, approximately 25 percent (323,252), were rejected.[40]

Form W-7 states that ITIN processing takes four to six weeks and instructs applicants to wait until the end of the six week period before inquiring about the status of their applications.[41] Unfortunately, the form refers applicants to the IRS' general toll-free number (1-800-829-1040) rather than a dedicated number at the Philadelphia campus, so ITIN applicants may experience confusion and delay given the number of menu choices on that line.

Once a taxpayer reaches the IRS, assistors can only determine the status of an application if it has been input to the system. Thus, if the application has not yet entered the system although it clearly was received, the assistor cannot help the taxpayer. Taxpayers are told to resubmit their applications if more than eight weeks have passed and there is no record of the Form W-7 in the system. However, the taxpayer may no longer possess the necessary documentation (for example, certified copies) to accompany the form. These delays and re-work increase the volume of W-7 applications sent to the campus for processing. In contrast to IRS taxpayer assistance, the U.S. Army provides more specific instructions to its troops by listing the IRS ITIN Customer Service Unit phone number and address, allowing for better tracking and service.[42]

Another possible factor contributing to delays in the ITIN application process is the lack of quality review of applications. An IRS study of the ITIN program found that IRS field

[37] Internal Revenue Service, *Individual Taxpayer Identification Number (ITIN), National Task Force, Final Report,* September 11, 2002, p. 9.

[38] Id.

[39] ITIN 4541, Philadelphia Campus report, September 6, 2003.

[40] ITINs may be rejected for a number of reasons, including (1) the taxpayer's name on the ITIN application does not match the name shown on identification documents; (2) the taxpayer enters the name of the country instead of an actual address in the "permanent address" box; (3) the taxpayer does not provide certified copies of identification documents. All of these are understandable errors: (1) upon arriving in the United States, many immigrants alter their names for simplicity, particularly those with hyphenated or multiple surnames; (2) taxpayers no longer have a permanent address in their host country; and (3) taxpayers are wary of sending original documents to the IRS and do not know how to obtain notarized or certified copies, or they must travel to a distant location to obtain official copies.

[41] IRS Form W-7, Application for the IRS Individual Taxpayer Identification Number (Rev. December 2002).

[42] Available at http://www.jagcnet.army.mil. Army troops may require ITINs for family members and military spouses.

assistance centers do not review the quality of Forms W-7 before sending them to Philadelphia for processing.[43] Routine processing delays are exacerbated when the IRS suspends or rejects applications because information is missing from a Form W-7, the form is outdated, or the documentation does not validate the applicant's identity or foreign status. If the Form W-7 is suspended, the IRS sends the individual a notice requesting the information by a certain date, then rejects the application if the taxpayer does not respond on time.

Form W-7 does not provide the taxpayer with a box to denote that he or she does not speak or read English, nor does it permit the taxpayer to designate a power of attorney that can receive information and communicate in English. IRS procedures state that if the taxpayer files a Spanish Form W-7 (Form W-7 SP), all future correspondence should be conducted in Spanish. In reality, however, the IRS sometimes sends English letters, notices and other documents to these taxpayers, imposing an additional burden on those who are trying to comply with the law.[44] Procedures established in IRS toll-free call sites also complicate taxpayers' attempts to seek assistance.[45]

Acceptance Agents and other organizations have reported they submitted many ITIN applications months before filing season so that returns requiring ITINs could be filed on time, but some individuals still did not receive ITINs until after the filing deadline.[46] Low Income Taxpayer Clinic (LITC) directors have also complained to the Taxpayer Advocate Service (TAS) about delays in processing ITIN applications. The LITC directors "were concerned that individuals required to report would not be able to file timely."[47]

During a recent focus group meeting, practitioners complained that "applications are accepted or rejected depending on who is conducting the review in Philadelphia."[48] For example, if different employees review the Forms W-7 submitted by several members of a single family, one employee may accept one application, while another employee may suspend or reject the others for varying reasons.

[43] Internal Revenue Service, *Individual Taxpayer Identification Number (ITIN), National Task Force, Final Report,* September 11, 2002, p. 10.

[44] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Revision 12-2002), p. 88.

[45] IRS toll-free sites direct taxpayers to an over-the-phone interpreting service only if they speak Spanish and advise those who speak other languages to obtain an interpreter and call back. While 53 percent of ITIN applicants are from Mexico, there are six bilingual Spanish-speaking employees available to translate applications and documents among the 196 staffers assigned to customer contact related work at the campus that processes Form W-7 applications. Source: Memorandum From Operations Manager, Accounts Management Operations 3, Seattle Remote Site, Subject: Seattle Accounts Management (AM) FY 2004 Call Site Guidelines.

[46] Filing Guidance for Taxpayers Waiting for ITINs, Email to Wage & Investment division SPEC, Stakeholder Partnerships, Education & Communication, March 6, 2003.

[47] Interview with Low Income Taxpayer Clinic Director, May 2003.

[48] ITIN Focus Group Interviews, Tax Forum, September 17, 2003.

ITIN Program Improvements

The difficulty in obtaining assistance and the processing delays involved in receiving ITINs place a significant burden on individuals who are attempting to participate in the tax system and comply with the law. To better serve this customer base, the IRS must improve the following aspects of the ITIN program.

ITIN Application Procedures

In 2002, the IRS recommended that individuals who apply for ITINs be required to file tax returns along with the ITIN application. In certain limited situations, taxpayers would also be able to obtain an ITIN without simultaneously submitting a tax return, so long as the taxpayer could demonstrate a tax administration purpose for issuing the ITIN. For example, taxpayers who have opened interest-bearing bank accounts need to supply the financial institution with a taxpayer identification number in order to avoid backup withholding on investment income. A taxpayer could be issued an ITIN if he or she attached proof of the financial account to the Form W-7.

The proposals described above are intended to discourage unauthorized use of ITINs (i.e., uses not associated with tax administration purposes). The National Taxpayer Advocate supports this underlying purpose. The ITIN is not a universal identity document and should only be issued in order to enable taxpayers to comply with their tax obligations.

The National Taxpayer Advocate is concerned, however, that these program changes will place unnecessary administrative hurdles before taxpayers who are complying with the tax laws, despite many practical barriers. As the IRS' own data show, under current application procedures, the vast majority of ITIN applicants are applying for and using ITINs for tax administration purposes. Thus, the IRS has not demonstrated a sufficient need for changing its current application procedures.

The absence of a tax administration or business case for change is particularly striking when one considers the delays inherent in applying for an ITIN number during filing season. First, the taxpayer's refund will likely be delayed for at least six to eight weeks due to the volume of applications.[49] If any of the typical processing problems occur, the taxpayer's refund will be further delayed. As a result, taxpayers will call or send follow-up correspondence during filing season, just when the IRS is experiencing peak volume.[50]

[49] Interviews with Latin American For Social Economic Development/Accounting Aid Society, Detroit; Midwest Tax Clinic Center for Economic Progress, Chicago; and First Commercial Bank, Oklahoma, May 2003.

[50] The National Taxpayer Advocate notes that the ITIN proposal pushes processing into the filing season, whereas the IRS case for its Earned Income Tax Credit precertification pilot is based in part on the premise that it is better to handle factual or document-intensive issues outside the press of the filing season.

The proposed process changes increase the likelihood that problems will arise.[51] If taxpayers are required to submit Forms W-7 with individual income tax returns, the two forms may become separated. The campus may send the return elsewhere for processing with a temporary Taxpayer Identification Number (not an ITIN). Taxpayers may later be confused about which number to use if the Form W-7 is processed later. The IRS might also send the taxpayer a notice instructing him or her to file a Form W-7 with next year's return, although the previous Form W-7 is already somewhere at Philadelphia waiting to be associated with a return.

Finally, the proposed changes will seriously hamper the successful efforts of the IRS Stakeholder Partnership, Education and Communication (SPEC) unit, the Taxpayer Advocate Service, the Hispanic Internal Revenue Employee Association (HIRE), Low Income Taxpayer Clinics, and other community groups to educate immigrant taxpayers about their rights and responsibilities as U.S. taxpayers. Currently, these organizations sponsor workshops, ITIN fairs, and outreach sessions throughout the United States, often in advance of the filing season. Immigrant taxpayers can attend these sessions, learn about the tax system and their filing obligations, and receive assistance in preparing their ITIN applications. These initiatives are particularly successful because taxpayers are less intimidated by hearing information from community partners than from the IRS. The proposed processing changes will hamper, if not eliminate, this valuable partnership and service. Thus, the IRS proposal is compounding, not improving, the problems associated with ITIN processing.

Taxpayer Assistance Centers

The IRS Taxpayer Assistance Centers are responsible for reviewing Forms W-7, Applications for Individual Taxpayer Identification Numbers, and their supporting documentation, and forwarding the information to the Philadelphia Campus for processing. Employees in the TACs can also check the status of ITIN applications online and provide this information to taxpayers. Former IRS Commissioner Charles Rossotti advised in a memorandum to the Department of Treasury that "the growth in requests for Form W-7 assistance at IRS TACs is having a direct effect on the ability to provide tax law and account service for other taxpayers in some parts of the country."[52] However, given the characteristics of the ITIN taxpayer population, many ITIN filers benefit from the face-to-face, personal assistance that the TACs offer.

[51] While W& I currently has program responsibility for the ITIN program, SB/SE has responsibility for processing ITINs. This disconnect between policy and operations is a source of confusion due to communication problems across the cross-functional business operating division, lack of executive oversight over resources, and competing priorities. Internal Revenue Service, Individual Taxpayer Indentification Number (ITIN) National Task Force, Final Report, September 11, 2002, p. 9

[52] Memorandum For General Counsel, Acting Assistant Secretary For Tax Policy, Assistant Secretary for Financial Institutions, From: Charles O. Rossotti, Commissioner of Internal Revenue Service, *Individual Taxpayer Identification Numbers*, August 12, 2002, p. 2

At the same time, taxpayer assistance centers should provide better service to ITIN applicants. TACs sometimes fail to spot missing information or supporting documentation on applications, which delays the process later on. This situation would improve if the IRS establishes quality measures for the accuracy of documents forwarded to Philadelphia.

The TACs must also establish clear and consistent guidelines for providing assistance in completing Forms W-7. Some offices only accept Forms W-7s on certain days, requiring applicants to go home and come back, often over long distances. Others offices will only assist 25 individuals a day with Form W-7 applications. The TACs must provide better communication about their hours of operation. If the TAC actions are established IRS policy, it should be publicized broadly, particularly through stakeholder groups.

Certified Acceptance Agents

Certified Acceptance Agents may receive and review the identifying documentation and submit the taxpayer's Form W-7 and letter of certification to the IRS campus.[53] As of November 2003, there were 653 Acceptance Agents: 576 in 36 states, the District of Columbia and Guam, and 77 others in 12 foreign countries.[54] The Treasury Inspector General for Tax Administration (TIGTA) identified the following problems regarding the use of Acceptance Agents.[55]

- There is no active IRS recruiting or training program for Acceptance Agents.
- There are no standard application forms or required background checks for Acceptance Agents.
- The IRS has not established goals, objectives, success factors, performance measures and adequate managerial oversight for the Acceptance Agent program.
- The IRS does not inform Acceptance Agents in a uniform or timely manner about changes to the program.

Clearly, the IRS could improve the accuracy of Form W-7 submissions and shorten delays by promoting, strengthening, and increasing communication to educate taxpayers through the Acceptance Agent program.

Returns with Mismatched ITINs and SSN

A "mismatch" return is an individual income tax return in which either:

(1) the taxpayer's name and Social Security number entered on the tax return do not match the information on record with the Social Security Administration, or

[53] Rev. Proc. 96-52, 1996 C.B. 372.

[54] "Acceptance Agent Program," available at http://www.irs.gov/individuals.

[55] Treasury Inspector General for Tax Administration, *Management oversight of the Acceptance Agent Program is Needed to Assure That Individual Taxpayer Identification Numbers Are Properly Issued,* Reference # 2002-30-026, November 6, 2002.

(2) the taxpayer identification number on the actual return form does not match the taxpayer identification number on one or more attached tax information statement, such as a Form W-2 (Wage and Tax Statement).

For purposes of assessing the tax due and triggering the statute of limitations period for assessment, refund claims, and collections, a mismatch return is considered a return. However, the return is not considered "processible" until the discrepancy between the taxpayer identification numbers is resolved.[56]

Although some mismatches are easily resolved - for example, where two digits are inadvertently switched - others are more complex and may involve identity theft. Persons who are in the United States without authorization to work may, in fact, be working. Employers are required to obtain proof of any prospective employee's identity and immigration status before employing that person.[57] Undocumented workers may submit an actual or fabricated SSN (and even identity) to a prospective employer. Thus, the worker's Form W-2 will reflect an incorrect SSN while his individual income tax return shows his actual ITIN.

Any procedure designed to resolve the SSN/ITIN mismatch must not interfere with the IRS' duty to help taxpayers comply with the tax laws. However, the IRS must also be concerned about those taxpayers whose SSNs are being unlawfully used. The IRS must develop procedures that will protect victims of identity theft from having to spend years proving to the IRS that they, in fact, did not earn the wages reported under their SSNs.

If the IRS requires a taxpayer who is working without legal authorization to submit an amended Form W-2 showing the taxpayer's ITIN, it is likely that the taxpayer will forego any refund and simply move on to another employer or enter the cash economy. Under this approach, then, the taxpayer does not fulfill his filing obligation and the victim of identity theft is not protected.[58]

A better approach, from the perspective of tax administration, would be to permit the taxpayer himself or herself to submit a substitute information document (Form 4852, Substitute for Form W-2, Wage and Tax Statement), listing the correct taxpayer identification number accompanied by proof that the taxpayer is indeed the person who earned the income shown on the form (e.g., a year-end paycheck stub). Upon receiving such proof,

[56] Appendix 1, Chief Counsel Opinion, UILC: 6109.00, SCANO-120953-02, June 13, 2002, Release Date August 16, 2002.

[57] U.S. Citizenship and Immigration Services, Form I-9, Employment Eligibility Verification. All U.S. employers are responsible for completion and retention of Form I-9 for each individual they hire for employment in the United States. This includes citizens and noncitizens. On the form, the employer must verify the employment eligibility and identity documents presented by the employee and record the document information on the Form I-9.

[58] The wages or other income reported under the victim's SSN will be traced to the victim via the IRS' automated underreporter (AUR) program. The victim will then have to spend hours of his or her own time - or pay a representative - to correct the IRS' record in order not to pay tax on income he or she did not earn.

the IRS can continue to process the return and issue any refund due. The IRS can also "fence off" the wages or other income from being attributed to the victim of identity theft.[59]

IRS data, however, does not indicate that taxpayers who file returns with an SSN/ITIN mismatch are reporting wages that they did not earn. The requirement that taxpayers attach a pay stub or similar documentation to their returns actually may discourage those taxpayers who are paid in cash from filing. Thus, the IRS has not shown a tax administration purpose for imposing an additional burden on this group of taxpayers.[60] The U.S. Census Bureau estimates there are seven million undocumented workers in the United States.[61] Since the IRS has not yet brought all of these workers into the tax system, it is incumbent on the tax administrator to remove barriers to filing rather than impose new ones.

Confidentiality of Tax Return Information

Nowhere is the importance of the confidentiality protections of tax return information under IRC section 6103 more apparent than with the taxpayer population using ITINs. Many of these taxpayers are residing and/or working in the United States in violation of immigration laws. The IRS' ITIN databank is understandably of interest to other federal agencies charged with enforcing the immigration laws and protecting national security.

Low Income Taxpayer Clinics and community service providers uniformly report that undocumented workers have a strong incentive to file tax returns because filing may be considered evidence of good moral character for immigration purposes.[62] Yet these taxpayers also express concern that by filing a tax return with an ITIN, the taxpayer will enable the IRS to share that information with immigration authorities. This concern acts as a deterrent to filing by this population. Confidentiality of ITIN information, then, is critical to encouraging undocumented taxpayers to file tax returns.

Even limited access to ITIN-holder's tax return information, beyond what Section 6103 currently permits, undermines the IRS' ability to fulfill its mission - helping taxpayers meet their tax obligations. In order for taxpayers to feel comfortable with voluntarily

[59] The taxpayer should also be required to submit the original Form W-2 along with the substitute W-2 so that the IRS can protect the actual "owner" of the SSN.

[60] At present, tax returns with SSN/ITIN mismatches cannot be filed electronically. It is not clear if, after the mismatch has been resolved - that is, where the ITIN shows on the substitute wage document as well as the actual return - the return could be electronically filed at that time. At any rate, the inability to file these returns electronically results in these taxpayers being denied return preparation assistance at IRS Taxpayer Assistance Centers (TACs), since the TACs only prepare returns that can be filed electronically.

[61] Based on the 2000 census and its own statistics, the Immigration and Naturalization Service (now the BCIS) reported that roughly seven million immigrants were living illegally in the United States as of January 2000.

[62] Immigration and Nationality Act sec 240A, 8 U.S.C. sec 1229b(b) (Supp. III 1997). For a general discussion of the tax problems of immigrant taxpayers, see Saulk Farooql and Fitzgerald Lewis, Immigration And Tax Law: A Curious Intersection, The Community Tax Law Report, Vol. 5 No. 2 Fall/Winter (2001).

reporting income and paying tax, they must have an expectation that, absent another agency showing a compelling need for a particular taxpayer's tax return information, the IRS will vigorously protect that information.[63]

IRS COMMENTS

We recognize the difficult issues raised by the ITIN Program and the challenge of properly and thoroughly attending to them. As noted in your report, based on the proportion of ITINs that have been used for tax purposes relative to the overall number of ITINs that have been issued, a majority of ITIN holders are compliant with tax laws. However, there are still significant issues that must be addressed to ensure that ITINs are issued and used for tax purposes and innocent taxpayers are not adversely affected by other persons using their Social Security numbers.

The Service has concluded that most resident aliens who hold ITINs and who report and pay tax from wage income are not legally employed in the United States. This is because such a taxpayer would have a valid SSN if the holder were legally employed in the United States, making procurement of an ITIN unnecessary and duplicative. The Service believes that most ITIN holders whose wages are reflected on valid Forms W-2 furnished to the Service are using stolen or fabricated SSNs, because employers are prohibited from employing individuals who lack an SSN and employers use the SSN provided by such employees in reporting Form W-2 information. The Service also believes that a substantial number of the ITINs issued have subsequently not been used for tax reporting and payment. It is widely believed that some ITINs are procured for the purpose of creating an identity, such as for the procurement of a driver's license. Because of this possibility, the Service has actively worked to make states aware of the limitations of ITINs and their unsuitability for determining identity, such as for the purpose of granting a drivers license. The Service is also fully sensitive to the possible dangers that can arise from the misuse of ITINs for the purpose of creating an identity, including the possible threat to national security.

Despite the distinctly undesirable behaviors actually or potentially associated with ITINs, the Service remains legally responsible for enforcement of the nation's tax laws with respect to ITIN holders. This includes the responsibility to assess and impose tax on ITIN holders irrespective of the circumstances of their employment or the possibility that ITIN applicants may be solely or collaterally seeking the procurement of an ITIN to establish an identity for non-tax purposes, and to pay refunds to ITIN holders in cases in which a refund is otherwise due.

[63] For a more detailed discussion and analysis of confidentiality, IRC § 6103, and various proposals for sharing ITIN information, *see* part 2 herein.

We have implemented fundamental improvements to the ITIN program this year and believe these enhancements represent an appropriate balance to resolve ITIN program deficiencies without unduly burdening either taxpayers or the tax system. We will evaluate these changes during the 2004 filing season and consider additional enhancements to the program in the future. Effective December 17, 2003, the IRS has implemented the following:

1. All new ITIN applicants must show a tax purpose for seeking the ITIN. In most cases, this will require attaching a tax return to the Form W-7, Application for IRS Individual Taxpayer Identification Number. We will no longer accept applications from individuals stating that they need an ITIN to file a return without proof that the applicant needs the number to file a return. Of all ITINs issued, approximately 15 percent of applicants have applied for an ITIN for a purpose other than filing an income tax return, such as to take advantage of a tax treaty or for other specified purposes. As before, applicants who are not required to pay income tax or to file a tax return will continue to be able to apply for an ITIN at any time throughout the year, subject to new requirements for furnishing documentary support for their need for an ITIN for tax purposes.
2. The number of documents the Service will accept as proof of identity to obtain an ITIN has been reduced from 40 to 13. The 13 acceptable documents are listed in the instructions for the revised Form W-7.
3. The appearance of the ITIN has been changed from a card to an authorization letter to avoid any possible similarities with a Social Security number card.

Your report raises several issues and concerns. IRS' comments regarding these concerns follow.

Processing Delays and Problems

We acknowledge that there have been delays in processing ITIN applications, which can, in turn, lead to other problems, such as delays in return processing. Certain factors may contribute to the likelihood that an applicant will experience a delay in the processing time of his or her Form W-7. Staffing constraints at the Philadelphia Submission Processing Center, where all applications for ITINs are processed, have led to delays. In addition, a significant number of ITIN applications we receive do not include adequate documentation. This requires the IRS to correspond with the applicant in order to resolve the documentation issue and adds more time to the processing of an application. Computer system problems during the last year caused further delays.

We are addressing ITIN application processing delays and problems. We are increasing staffing in the Philadelphia ITIN unit to ensure that ITIN applications accompanied by a tax return will be processed in two weeks' time. This will also provide timely processing of the ITIN applicant's tax return and furthers the IRS' overarching priority to process returns timely. In addition, Philadelphia will transship tax returns (other than those attached to a Form W-7) to another campus site for processing, when warranted, rather than divert resources from processing ITIN applications. Taxpayer Assistance Centers (TACs) will continue to accept ITIN applications, verifying the documentation and forwarding the applications with returns attached to Philadelphia. ITIN applications accepted by TACs require substantially less resources to process for Philadelphia. This will also reduce processing delays.

Your report notes that Acceptance Agents have reported delays in IRS processing of Forms W-7. There were delays with applications submitted by Acceptance Agents during 2003 because of changes made to the Form W-7 and its accompanying instructions in December 2002. Even though the form was changed in December 2002, the Service delayed the mandatory use of the new form until after April 15, 2003, in order to minimize the impact of the form's new requirements. We provided information alerts to all Acceptance Agents concerning the changes made to the Form W-7, and posted bulletins on the Service's Internet site, www.irs.gov. In spite of our attempts to mitigate confusion concerning the requirement to use the new Form W-7 after April 15, 2003, the continued use of obsolete forms and the failure to provide required documentation after that date required the IRS to reject a large number of applications. The Philadelphia Submission Processing Center worked with the Acceptance Agents to resolve these problems on a case-by-case basis to minimize any adverse impact on their clients.

Your report also identifies concerns among practitioners that acceptance or rejection of an ITIN application may depend upon the reviewer to whom the application is assigned at the Philadelphia Submission Processing Center. IRS acknowledges that there are situations, as with any large volume of work, when decisions on applications are affected by the performance of individual employees. There are well over one million W-7 applications processed each year. Prior to the changes we have now implemented, over 40 documents were acceptable to allow an applicant to establish identity and foreign status, with variations in format, content, and language, depending on the country of origin. These variables can lead individuals to reach different determinations on the validity of documents in different cases. However, we expect the reduction in the number of allowable documents (from 40 to 13), combined with additional training planned for this filing season, to improve the ITIN application process and lead to more consistent results.

Moreover, an independent unit will review a sample of each employee's work weekly. Employees that do not meet a 90 percent accuracy standard are documented and corrective actions are taken.

Your report takes issue with IRS directing ITIN-related questions to its general toll-free telephone number. As with most tax-related questions directed to the toll-free number, IRS does not know what information customers may need when they pick up a Form W-7. They may have a general question about completing the form, a question about a pending application, or a more technical question concerning international tax issues. Furthermore, it is our experience that customers often use the general toll-free number even in situations where IRS has established "specialty" numbers, such as for responding to tax questions related to the September 11 terrorist attacks, since this general toll-free number is published in telephone directories and most tax publications and instructions.

As with all taxpayers, those with inquiries concerning ITINs are required to navigate the IRS toll-free menu choices, and, as with all taxpayers, a caller with an ITIN inquiry will reach an assistor-speaking either English or Spanish, as may be necessary-who has the tools to answer the caller's specific questions. Systems are in place to efficiently transfer Spanish-speaking customers to a Spanish-speaking employee. We have found this to be a more effective method for serving ITIN customers than attempting to respond to such calls in the Philadelphia ITIN unit, whose primary mission is timely processing of ITIN applications.

IRS acknowledges that it is an error when English notices are sent to applicants that apply for an ITIN using the Spanish version of the application, Form W-7SP. However, these situations are inadvertent and, we believe, rare.

ITIN Program Improvements

ITIN Application Procedures. We have outlined above changes we have implemented to the ITIN Program, including changes to the ITIN application procedures. These changes were implemented to better regulate the issuance of ITINs and will assist in ensuring they are used for the purpose for which they were created, tax administration. The Service is fully sensitive to the possible dangers that can arise from the misuse of ITINs for purposes of creating an identity, including the possible threat to national security. This is one of many factors that we considered in implementing changes to the application procedures.

New procedures affecting the filing of tax returns create a risk for problems arising during the filing season, including potential refund delays. We have taken steps, described above, to mitigate this risk and will be evaluating these changes during the filing season.

If needed, will make changes or take additional actions to assure timely processing of ITIN applications.

We have instituted procedures and will have trained employees to ensure that Forms W-7 remain together with any attached return, until the ITIN is assigned. In addition, IRS has procedures to ensure any Forms W-7, with or without any attached returns, which are received in other campuses will be promptly forwarded to Philadelphia for processing. All taxpayer communications and forms/instructions include specific reminders to taxpayers applying for an ITIN to follow the instructions in the Form W-7 directing them to mail the ITIN application and attached return to the Philadelphia Submission Processing Center.

Your report documents your concern that changes to ITIN Program administration and application procedures will hinder outreach efforts to educate immigrants about their rights and responsibilities as United States taxpayers. IRS' Stakeholder Partnership, Education and Communications (SPEC) unit employees, partners, and volunteers will continue to conduct outreach sessions geared toward educating the public on the uses and application of an ITIN. At outreach sessions we will continue to provide assistance in completion of Forms W-7. SPEC products used for ITIN education are available in English and in Spanish translation. In addition, SPEC relies on partners that serve other Limited English Proficiency taxpayer groups to communicate ITIN application procedures and requirements in languages for which there are no IRS printed documents. SPEC volunteer tax preparation sites will provide assistance with completion of a tax return that can be submitted with the Form W-7 application. In addition, SPEC partners will support VITA sites with direct W-7 application assistance. While there may be a decline in the number of applicants for ITINs at IRS outreach sessions due to the new requirements, the changes will not hinder the educational efforts and impact of IRS partners and volunteers within the community.

Taxpayer Assistance Centers. The Service agrees that many ITIN filers benefit from the fact-to-face personal assistance that TACs offer. TACs will continue to provide such assistance for ITIN applicants. IRS expects that the reduction in the number of identification documents accepted from ITIN applicants will allow TAC employees to provide better and more consistent service to applicants. In addition, the effect of the changes in ITIN application procedures will substantially improve the quality of the applications that are forwarded to Philadelphia from the TACs and will thus decrease further communications that would otherwise delay approval of the application. It is also important to point out that the quality of the applications received from TACs is much higher than those received either from Acceptance Agents or those submitted directly to Philadelphia from the applicants. Other factors also ensure continued quality assistance to ITIN applicants at TACS. For example, group managers conduct sample reviews of Forms W-7 when reviewing employees, and "Embedded Quality" will be implemented in TACs in May 2004, thus increasing the number of Forms W-7 being reviewed.

With regard to your statement that TACs should establish clear and consistent guidelines for providing assistance in completing Forms W-7, we note that the demand for assistance from ITIN applicants varies greatly geographically. In order to provide assistance to all taxpayers, who may have issues such as payments, tax law questions, or account problems in addition to ITIN questions, TAC sites must have the flexibility to address the demand based on available staffing and space resources. TACs have made use of several possible options to ensure that all taxpayers are able to receive assistance, including working ITIN applications on certain days, using appointments, and limiting the number of ITIN applicants assisted each day.

Certified Acceptance Agent. We agree that the Acceptance Agent program needs to be improved and expanded, as set forth in the IRS response to the TIGTA report cited in your report. These changes are planned for FY 2004. The program has been expanding; there are currently over 1,300 "certifying" acceptance agents, an increase of approximately 17 percent since January 2003. Also please note that the Acceptance Agents listed on the irs.gov Internet site represent only about 50 percent of all Acceptance Agents. Those that offer their services only to their clients (as opposed to offering them to the general public) are not listed, including educational institutions, military installations, gambling associations, and investment companies.

Returns with Mismatched ITIN and SSN. The IRS is considering a number of potential actions to address issues arising from returns filed with an ITIN, and having supporting documentation showing an SSN. One such program whose merits we are considering is a taxpayer identification number (TIN) validation system for use by employers. TIN validation would allow employers to verify the name/TIN combination provided by a prospective or current employee against the Service's records. Such a system is technologically feasible, would provide benefits to tax administration, and would address some of the issues with respect to the use of stolen or fabricated SSNs by resident aliens. However, disclosure of the existence of a mismatch to an employer would be inconsistent with the statute ensuring confidentiality of taxpayer information, Section 6103 of the Code. Legislation currently under consideration in the Senate would provide the explicit authority necessary to overcome the general prohibition, allowing the Service to disclose mismatches to employers. The provision is Section 413 of the Tax Administration Good Government Act, S. 882. We believe that TIN validation could be an important tool in discouraging and resolving mismatches. Absent specific authority, though, we are unable to implement a TIN validation system for use by employers.

Confidentiality of Tax Return Information. The IRS is prohibited under Internal Revenue Code section 6103 from sharing information provided to it on a Form W-7 or any other tax information with other agencies, with few exceptions. Thus a legislative change to Section 6103 would be required before the Service could share such information. Moreover, the Department of the Treasury's position on legislative changes to Section 6103 is that "additional exceptions to the confidentiality of taxpayer information under section 6103 should be granted in rare circumstances and only where the requesting agency can demonstrate, using established criteria, a need for the information that clearly outweighs taxpayer privacy interests and concerns about the effect on voluntary tax compliance." (See Department of the Treasury's October 2000 Report to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions.)

Lastly, the Service wants to acknowledge the assistance the National Taxpayer Advocate provided in framing issues arising from the Service's use of ITINs, and in considering possible responses to the challenges that ITINs present to tax administration. As a result of her assistance, the actions recently implemented by the Service strike a better balance between the potential benefits of these changes and their costs to the tax system, including the indirect costs that arise from discouraging participating in the tax system.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the IRS for its approach to the difficult problems that ITINs pose for tax administration. She believes that the current procedures are a legitimate attempt to "strike a better balance" between many competing objectives. Perhaps the most important result of these changes is the clear message to taxpayers and others that ITINs are not, in fact, identity documents and that their issuance is dependent on a demonstrated tax administration purpose.

These procedures are not without flaws, however, and the IRS is likely to experience any number of administrative glitches. Nevertheless, we are pleased with the IRS' efforts to ensure that ITIN applications submitted with returns attached are timely processed within two weeks. We are also pleased that the IRS has established high quality standards for ITIN processing.

The Taxpayer Advocate Service applauds the IRS for confirming its commitment to TAC assistance and to support LITCs, VITA and TCE sites that either assist in preparation of ITIN applications or *have taxpayer/clients who require such assistance. The National Taxpayer Advocate recommends that where TACs, due to resource or time management constraints, establish parameters for ITIN assistance, such parameters should be well-advertised, both on the local TAC phone line and in outreach materials. Further, if taxpayers show up for ITIN assistance outside of those timeframes, the TAC should advise the taxpayer of (and also post) alternatives for obtaining assistance, including a list of local acceptance agents, and LITCs and VITA sites that assist in Form W-7 preparation.*

In its response, the IRS acknowledges that,

"… there are still significant issues that must be addressed to ensure that ITINs are issued and used for tax purposes and innocent taxpayers are not adversely affected by other persons using their Social Security Numbers.

… The Service believes that most ITIN holders whose wages are reflected on valid Forms W-2 furnished to the Service are using stolen or fabricated SSNs, because employers are prohibited from employing individuals who lack an SSN and employers use the SSN provided by such employees in reporting Form W-2 information."

The use of stolen SSNs for tax purposes creates serious problems for the victims of this identity theft. Innocent taxpayers are subject to audit on wages and other income that is not theirs. While we are pleased that the IRS has identified and highlighted the tax consequences of SSN identity theft, we are concerned that the IRS has not described any plans for devising a method to prevent these taxpayers, who are the victims of identity theft, from being audited needlessly. The National Taxpayer Advocate strongly recommends that, to achieve balance in tax administration, the IRS make such a program a priority. For example, when a tax return is submitted under an ITIN and wages on the return are reported on a Form W-2 under an SSN, the IRS has enough information to suspect that the wages were earned by the ITIN holder and not by the SSN holder. Yet the IRS currently lacks the ability to act on this information. Under existing IRS procedures, the SSN holder would receive a notice stating that he had under-reported income and therefore owed tax, interest, and possibly penalties. The SSN holder would then have to prove that the wages in issue were not his. The IRS should develop the capability to associate the receipt of a return reflecting an ITIN/SSN mismatch with the tax record of the true SSN holder to prevent the issuance of unwarranted notices or, at a minimum, to make the fact of the mismatch accessible to IRS personnel who would be dealing with the SSN holder.

The National Taxpayer Advocate is concerned about certain aspects of the Service's proposed TIN validation program. It is true that this program would generate tax administration benefits by reducing the number of mismatched information return documents. Current legislative proposals limit the release of information under this program to a third party – be it employer or financial institution – to a "match/non-match" acknowledgement.[64]

The procedure as proposed, however, is not without risk. First, a non-match acknowledgement may cause employers to not hire persons, without giving them the opportunity to cure the defect. This can be particularly problematic for divorced women and persons with hyphenated and compound surnames.

Second, it is very likely that by reporting a non-match to employers, taxpayers who are working in the U.S. without proper immigration authorization will not cease working or stop using the incorrect TIN. They will simply move to the cash economy, with all its attendant problems for tax administration. That result will not improve tax administration, nor will it protect the victims of identity theft.

Third, and most important, there is strong empirical evidence from a test conducted by the Social Security Administration that requesting corrections of mismatches from employers is not effective. To the contrary, the Social Security Administration found that contacts with the taxpayer himself or herself is the most effective approach.

Thus, the National Taxpayer Advocate recommends that the TIN validation program be tested first as a pilot to determine whether the error resolution rate (a tax administration benefit) outweighs the impact to taxpayer privacy and other aspects of tax compliance. As part of this test, the IRS should conduct two samples. In one sample, the fact of match/mismatch acknowledgement should be sent to the employer or financial institution; in the second sample, the match/mismatch acknowledgement would be sent to the taxpayer. Armed with the results of this pilot, Congress can determine if it is necessary to amend IRC § 6103, and if it is, how best to do so while protecting the taxpayer's privacy interests.[65]

Finally, the National Taxpayer Advocate must again point out, as the IRS acknowledges, that ITIN procedures, however efficient they appear at first blush, must be carefully tested in order to avoid negative impacts on tax compliance. Moreover, Congress and the IRS must be watchful to not allow the IRS to be drawn into the routine enforcement of immigration laws. As the IRS notes, the Service "remains legally responsible for enforcement of the nation's tax laws with respect to ITIN holders.

[64] S822, 108th Congress, § 413 (2003).

[65] For an in-depth discussion and recommendations regarding IRC § 6103 and confidentiality and disclosure of returns and return information, see the Key Legislative Recommendation, part 2 *infra.*

This includes the responsibility to assess and impose tax on ITIN holders irrespective of the circumstances of their employment . . . and to pay refunds to ITIN holders in cases in which a refund is otherwise due."[66]

The National Taxpayer Advocate commends the IRS for dealing with the ITIN program's many difficult policy and administrative issues in an open-minded and flexible manner. She looks forward to continuing to work with the Service as it implements and improves the ITIN program.

[66] The 1,080,973 TY 2001 returns with ITINs as a primary or secondary TIN reported $3,392,053,749 in net taxes due and $214,261,788 in refunds. Source: IRS Wage and Investment Division Research, October 19, 2003.

PROBLEM

TOPIC #6 **MOST SERIOUS PROBLEM: COMBINATION LETTER**

RESPONSIBLE OFFICIALS

Henry O. Lamar, Commissioner, Wage and Investment Division
Dale Hart, Commissioner, Small Business/Self-Employed Division

DEFINITION OF THE PROBLEM

The Internal Revenue Service's correspondence examination units have merged two distinct audit letters, the initial contact letter and the 30-day letter, which includes the preliminary audit report and grants appeal rights, into one "combination letter." This combined letter is intended to shorten the time required for correspondence examinations and maximize employee resources. However, combining the two distinct audit letters significantly compresses the time given the taxpayer to respond and submit documentation and reduces the likelihood that the taxpayer will respond.

The combination letter requires the taxpayer to request an administrative Appeals hearing at the same time he or she is submitting information to the examination unit. Taxpayers may file a "protective" appeals request when the issue could be resolved during the examination if additional time were allowed. Similarly, the IRS also incurs a burden when Examination, Appeals, and Counsel personnel must address unresolved examination issues, either in audit reconsiderations or in litigation. These downstream expenditures lessen the employee resource benefits realized by the correspondence examination units.

ANALYSIS OF THE PROBLEM

The Combination Letter

In 1999, the IRS began using a combination letter (Combo Letter) in the correspondence examinations conducted on IRS campuses, replacing two separate letters that were previously issued at different times. The combination letter is the combination of the Initial Contact Letter and the 30-Day Letter. The 30-Day letter contains the preliminary audit report, reflecting the tax that will be due if the taxpayer fails to corroborate the issue.

Prior to use of the Combo Letter, the IRS first sent the Initial Contact Letter, which informed the taxpayer of the correspondence examination, stated the specific items under examination, and asked the taxpayer for documentation to verify the amounts on the tax return for the items being examined. The taxpayer was given 30 days from the date of the letter to provide the requested information.

At the end of the 30-day period, the 30-Day Letter was issued. It contained the preliminary audit report, showing the tax that would be due if the items under examination were not substantiated, and included information on the taxpayer's appeal rights. The taxpayer was given 30 days from the date of the letter to respond with additional documentation and/or request an Appeals conference. If the taxpayer responded to the 30-day letter with insufficient documentation, a letter requesting additional information (and also including the audit report) was mailed to the taxpayer, giving him or her an additional 15 days to respond.

If the taxpayer did not request an Appeals conference by the end of this second 30-day period, the Statutory Notice of Deficiency (commonly called the 90-Day Letter) was issued, requiring the taxpayer to file a petition with the United States Tax Court if he or she wished to litigate the adjustments before assessment and payment. Thus, the taxpayer had 60 days or more from the initial contact letter to the issuance of the 90-Day Letter, to work with the examiner to determine the correct amount of tax.

With the advent of the combo letter, which merges the initial contact letter and the 30-day letter into one, the taxpayer is given only 30 days to accomplish the same set of requirements. However, as before, the IRS will send the taxpayer another letter giving an additional 15 days to respond if he or she responded to the combo letter with insufficient information. The differences between how the IRS conducted correspondence examinations before and after the "combo letter" was instituted are illustrated in Table 1.6.1.

TABLE 1.6.1, PRE/POST COMBO LETTER PROCESSING

IRS Contact	Pre-1999 procedures	Post-1999 procedures
1st Contact from IRS	Letter 556 – Initial Contact Letter. Notifies the taxpayer of the examination and requests substantiation of the items in question. Provides 30 days to respond.	Letter 566B - Combo Letter - Notifies the taxpayer of the examination and appeal rights and requests substantiation of the items in question. Provides 30 days to respond.
2nd Contact from IRS	Letter 525 - 30-day Response Letter – Issued if no response or insufficient response is received from the taxpayer. Notifies taxpayer of appeal rights and includes a document request for additional proof. Provides 30 days to respond.	Letter 692 (SC/GC)- Revised Report/Additional Information Letter – Issued if insufficient response received from the taxpayer. Allows taxpayer to submit additional information. Provides 15 days to respond.
3rd Contact from IRS	Letter 692 – Revised Report/ Additional Information Letter – Issued after Letter 525 if insufficient response is received from taxpayer to allow taxpayer to provide additional information. Provides 15 days to respond.	Notice of Deficiency – the legal document providing notice of the proposed deficiency and instructions for petitioning the United States Tax Court. Issued if no response to the Combo Letter is received (including a request for Appeals conference) or issued after Letter 692 response is not sufficient. Also known as the 90-day letter.
4th Contact from IRS	Notice of Deficiency – the legal document providing notice of the proposed deficiency and instructions for petitioning the United States Tax Court. Issued if no response to Letter 525 is received (including a request for Appeals conference) or issued after Letter 692 response is not sufficient. Also known as the 90-day letter.	The taxpayer has either petitioned the Tax Court or the case has been moved to the IRS collection division to collect the funds owed per the additional assessment.

The combo letter affects a significant number of taxpayers. In fiscal year (FY) 2001, Correspondence Examination units on IRS campuses conducted 401,448 Earned Income Tax Credit (EITC) examinations, 9,624 nonfiler examinations, and 129,830 other examinations for a total of 540,902 examinations.[1] All were processed through the Report

[1] Treasury Inspector General for Tax Administration, *Trends in Compliance Activities Through Fiscal Year 2002*, Reference # 2003-30-078, March 2003, p. 37.

Generation Software (RGS) system, which was designed to process audit cases systemically and efficiently.[2] RGS automatically generates the "combo" letter with its attachments, giving the taxpayer 30 days in which to respond, and the statutory notice of deficiency, if one is required. The attachments to the combo letter include:

- Form 4549, Income Tax Examination Changes, showing the tax computation and items adjusted,
- Form 886, Explanation of Items, giving the list of supporting documents the taxpayer is requested to provide for substantiation of the adjusted items, and
- Publication 3498, The Examination Process, which includes information on the audit process and the appeal rights available to the taxpayer.

The result of the letter is that taxpayers must, within 30 days:

- Gather and mail or fax the requested substantiation for disallowed items to the Campus Examination unit;
- Await notification that the submitted documents are acceptable or a denial if the supporting documents are not acceptable;
- If not acceptable, request a conference with the Appeals Division; and
- Obtain professional assistance if help is needed to navigate through the examination process.

Taxpayers may find that 30 days is insufficient to obtain documents such as birth certificates, marriage licenses, Social Security cards, school records, and other requested items. Taxpayers who have limited proficiency in English or who otherwise do not understand what is being requested must take the additional step of obtaining help from friends, relatives, or tax professionals. Thus, the 30-day period creates a significant hardship for many taxpayers.

In addition, if the taxpayer has not received notice from the examining unit that the submitted documentation was not accepted, he or she might let the 30-day period lapse without knowing an appeal may be necessary. This uncertainty leads many taxpayers to file "protective" appeals requests, either simultaneously with or instead of submitting information to Examination.

The notice of deficiency is a legal document that is issued automatically if the taxpayer does not respond to the combo letter, or if the taxpayer and the examiner cannot agree on the proposed adjustments and the taxpayer does not request an appeals conference. While the IRS does not issue the notice for at least 60 days after it sends the combo let-

[2] Internal Revenue Manual (IRM) 4.19.1.4.10 (2).

ter, the taxpayer is told in the combo letter that he or she has only 30 days to respond.[3] Based on this IRS statement, if the taxpayer cannot obtain or locate documents within 30 days, he or she may assume it is too late to respond. The taxpayer may also be confused about whether information should be sent to Examination or held for an Appeals conference and may not understand when to request an Appeals conference.

The taxpayer will receive a notice of deficiency if he or she does not request an Appeals conference. After the notice is issued, the taxpayer has 90 days to petition the Tax Court to hear the case.[4] If he or she does not file a petition, the IRS assesses whatever tax, penalties, and interest are due.

When a case is petitioned to the Tax Court, it places a further burden on both the taxpayer and the IRS because of the additional time and expense required to resolve the matter in court. The cost to the taxpayer of filing a petition is $60.00, although the fee may be waived for those who are unable to pay.[5] The taxpayer may also choose to be represented in court by counsel, thus incurring additional fees for an attorney or other representative.

The litigation costs to the government are substantial. The Appeals Division will be involved in attempting to settle the case before trial if the taxpayer has not previously had an Appeals conference. If a settlement cannot be reached, then attorneys in the Office of Chief Counsel must prepare the case for trial in the Tax Court.

Appeal Rights

Letter 566B, the current 30-day combo letter, contains two references to the appeals process. The first reference states, "We will review what you send us and contact you as soon as possible. If you still disagree with our findings after we review your response and any additional information you provide, you have the right to file an administrative appeal as explained in the enclosed Publication 3498, The Examination Process." The second reference states, "Publication 3498 discusses your rights as a taxpayer and includes general rules and procedures during and following the examination process. It also explains appeals and payment procedures and outlines ways we can assist you."

Letter 566 B-EZ(SC)[6] contains only one reference to the appeals process: "After we review what you've sent us, we will contact you with the results. If you still disagree with our findings, you have the right to file an administrative appeal as explained in the enclosed Publication 3498, The Examination Process."

[3] IRM 4.19.1.4.4(4). If no reply, purge file on the 45th day for tax examiner preparation of proposed report. If contact letter (566B-EZ, 525, etc.) included report, purge file on the 60th day for preparation of Statutory Notice of Deficiency.

[4] IRS § 6213(a). A petitioner who is outside the United States at the time the Notice of Deficiency is mailed has 150 days to file a petition with the Tax Court. Once the Notice of Deficiency is issued, the taxpayer may still request an Appeals conference, but the 90 day period to petition the Tax Court will continue to run.

[5] Tax Court Rule 20(b).See http://www.ustaxcourt.gov.

[6] Letter 566 B-EZ (SC), Simplified Service Center 30 ICL/30 Day Combo Letter, is a simplified letter sometimes used in place of Letter 566 B.

Publication 3498, which provides guidance on how to appeal examination decisions, accompanies the combo letter. However, neither the letter nor the publication adequately covers the specific steps necessary to request an appeal. Nor do they clearly state that the timeframe, the 30-day period for requesting an appeal, began when the taxpayer received the combo letter. If for any reason the taxpayer does not understand the requirements, he or she may lose the opportunity for an administrative Appeals hearing before issuance of a notice of deficiency.

The Internal Revenue Service Restructuring and Reform Act of 1998 states: "The Secretary of the Treasury or the Secretary's Delegate shall . . .. include with any first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals an explanation of the entire process from examination through collection with respect to such proposed deficiency, including the assistance available to the taxpayer from the National Taxpayer Advocate at various points in the process."[7] Treasury Regulations, which outline how the IRS will implement the law, includes the following: "An oral request is sufficient to obtain Appeals consideration in all office interview or correspondence exam cases."[8]

The procedures and correspondence used in Correspondence Examination do not give the taxpayer adequate notice or opportunity to request an administrative appeal. The "Combo" letter states, "...you have the right to file an administrative appeal as explained in the enclosed Publication 3498, The Examination Process." However, Publication 3498 advises the taxpayer to "...follow the instructions in our letter to you by sending a brief written statement requesting an appeals conference."[9] The publication makes no mention of the fact that an oral request is permissible and sufficient under the law.

The instructions provided in the combo letter and Publication 3498 are confusing and do not ensure that taxpayers are made aware of their appeal rights. The consolidation of batch processing and the use of the "combo" letter have, in this respect, failed to provide adequate notice of a taxpayer's right to appeal. The taxpayer needs clear instructions detailing what actions to take if he or she does not agree with the proposed changes - without having to cross-reference between the letter and an eight-page publication.

The IRS also has not provided adequate instructions and a full description of the taxpayer's appeal rights to examiners handling the Campus Examination toll-free phone lines. The on-line Examination Toll-Free Telephone Procedural Guide (also known as Script),

[7] Internal Revenue Service Restructuring and Reform Act of 1998; Pub. L. No. 105-206, Title III, Subtitle F, §3504, 112 Stat.771. Explanation of Appeal and Collection Process.

[8] Treas. Reg. § 601.106(a)(iii)(a).

[9] Internal Revenue Service, *The Examination Process*, Publication 3498 (Revision 1-2003), p. 6.

which provides questions and responses for resolving audit issues, contains no information to assist taxpayers who ask about appeals procedures.[10]

Once the IRS sends a statutory notice of deficiency, the taxpayer has 90 days to petition the Tax Court to re-determine the amount of tax before assessment. The taxpayer may still request an administrative appeal during the 90-day period, but the 90-day period continues to run.[11] Neither the notice, Publication 3498, nor the Script clearly describes that right. If a taxpayer is granted administrative Appeals consideration, he or she may mistakenly believe it is not necessary to file a petition with the Tax Court, thus losing the right to take the case to court before paying the tax, in the event that an agreement cannot be reached with Appeals.[12] Therefore, it is imperative that the taxpayer be made aware of the necessity of filing a petition after the notice of deficiency is issued, even though he or she is working with Appeals in an effort to resolve the case.

IRS COMMENTS

IRS began use of the Combo Letter to reduce the time it took taxpayers and the Service to complete a correspondence audit. We recognize that some of the Advocate's concerns have merit. In an effort to resolve these concerns the National Taxpayer Advocate and the IRS have agreed to test the concept of sending an additional 30-day letter to the 25,000 taxpayers in the EITC certification proof-of-concept who do not respond to our request for certification information. The EITC proof-of-concept provides a perfect opportunity for us to test the 30-day letter concept and determine if it positively impacts the response rate of those taxpayers who initially do not respond to our requests for documentation.

The results of this test will determine the validity of the recommendations and determine the future process used by the IRS in the performance of our audits. We will evaluate the results using the following factors as success measures:

- Does issuing an additional 30-day letter reduce the percentage of taxpayers who initially fail to respond and/or reduce the percentage of taxpayers who initially respond and then stop?
- Does issuing an additional 30-day letter result in more taxpayers taking advantage of the IRS Appeals process?
- What impact, if any, does issuing the additional 30-day letter have on the overall cycle time of examination cases?

[10] IRM 4.19.1.8.3(2).

[11] Treas. Reg. § 601.106(b).

[12] The average administrative appeal took 293 days in tax year 2000, far beyond the allotted 90 days to petition the Tax Court. Treasury Inspector General for Tax Administration, *Taxpayers Should be Informed of the Benefits of the Fast Track Mediation System,* Reference #2002-10-070, March 2002.

During the EITC certification test, in addition to the Combo Letter, we will send a 30-day letter prior to issuing the 90-day letter to those taxpayers who either do not respond initially or those who start responding and then quit. This 30-day letter will be sent as a courtesy in an attempt to solicit a response from the taxpayer. The results of this test will determine if using the 30-day letter decreases the percentage of no-response rates currently being experienced by the IRS. If it does result in a substantial decrease in no-response rates, we will consider implementing the 30-day letter in all Examination correspondence examinations when taxpayers do not respond.

We believe that this test is essential to gathering sufficient data to either confirm the Taxpayer Advocate's assertion regarding the combo letter or to validate its appropriate use in our correspondence audit process. The test should be completed and the results evaluated by the summer of 2004.

The Taxpayer Advocate assumes that taxpayers are less likely to respond because they do not have the additional 30 days in which to respond and that the combo letter does not clearly identify the taxpayer's appeal rights within the IRS. This does not give adequate consideration to the history of non-responsiveness by taxpayers who are clearly not entitled to the items they claimed on the tax return, regardless of the length of time they have to respond. For those taxpayers who do agree with the assessment, the issuance of the combo letter removes 30 days from the processing time of the case, giving the taxpayer an opportunity to pay the assessment and stop additional interest and penalties from accruing. The supposition that taxpayers are forced to file "protective" appeals requests is not supported by any study or existing data. The fact that a taxpayer can still resolve their issues with the Internal Revenue Service even during the 90-day letter period is also not considered by the Advocate. Also there is no empirical data to indicate that taxpayers understand their appeal rights better if they are mentioned twice in a letter instead of once.

The Taxpayer Advocate's Report lists several concerns surrounding the Appeals and Petition process. The majority of the concerns relate to the absence of information in the Combo Letter and Publication 3498 explaining how and when the taxpayer may Appeal or Petition. Since the Examination, Appeals and Petition processes are complex and clarification would require extensive explanation, the IRS has chosen to refer the taxpayer to Publication 3498, which describes each process in detail and is currently under revision to further ensure clarity. We expect the revised Publication 3498 will address the Advocate's concerns.

The balance of the concerns relate to the fact that the On-line Examination Toll-Free Telephone Procedural Guide does not include information concerning the administrative appeal during the 90-day process. IRS is revising the guide to include the information. It should be noted that taxpayers who respond in writing to the 90-day letter are given written clarification explaining that we will continue to work with the taxpayer during the 90-day process but if they chose to petition Tax Court it must be within the 90-day period.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate remains concerned about the use of the "combo" letter (566 B) by Correspondence Examination on IRS campuses. TAS recognizes the procedural efficiencies of the RGS batch processing system. However, these letters cause a significant burden to the receiving taxpayers by treating them differently from other taxpayers under audit. They receive separate notice of appeal rights instead of one letter combining both exam and appeals information. In addition, the "combo" letter does not adequately explain appeal rights, resulting in a possible abridgement of taxpayer appeal rights, as mandated by RRA 98 § 3465.[13] *This letter does not constitute notice of appeal rights to its intended recipients.*

The National Taxpayer Advocate's concern with respect to the use of the combination letter is twofold:

- *First, the combination of two significant and contradictory instructions - respond to exam but also request an appeal - is confusing, and the wording and layout of the letters is unclear.*
- *Second, and more important, the conflation of exam contact and appeals information is insufficient notice of a taxpayer's right to an Appeals hearing.*

IRS TWO-LETTER EITC TEST

The IRS response emphasizes its pilot during the EITC certification program, in which it will "test" a two-letter process, one of which it is sending as a "courtesy" to the taxpayer. The IRS states that It will evaluate this pilot and determine it to be a success on the basis of any changes to the no-response rate for such audits.

The National Taxpayer Advocate finds this response unsatisfactory. A taxpayer's actual response (or lack thereof) to notices is not the appropriate measure of a notice's adequacy in meeting fundamental due process requirements. Before one can accurately measure or determine an adequate response rate to a notice, the notice itself must pass scrutiny as to whether it informs the taxpayer of

[13] Internal Revenue Service Restructuring and Reform Act of 1998; Pub. L. No. 105-206, Title III, Subtitle F, § 3465, 112 Stat. 767. Internal Revenue Service Procedures Relating to Appeals of Examinations and Collections.

- *What the government is proposing to do;*
- *What is the impact of the government's action on the taxpayer; and*
- *What procedural rights are available to the taxpayer to challenge the government's proposed action.*

Without clear notice of this information, the taxpayer cannot make an informed decision about how to proceed. It is, of course, entirely likely that a taxpayer, having received clear notice of the government's intent, the reason behind that intent, and the right to appeal, will decide not to respond. The key difference in this case, however, is that the taxpayer will be making an informed decision and not one out of ignorance.

The IRS states that "there is no empirical data to indicate that taxpayers understand their appeal rights better if they are mentioned twice in a letter instead of once." The National Taxpayer Advocate is not asking for the IRS to "mention" appeal rights twice in a letter. She is asking the IRS to describe appeal rights (and the method for obtaining them) once in a separate letter dedicated to that issue. LMSB taxpayers are among the most sophisticated, yet the IRS sends them two separate relatively clear letters. Taxpayers claiming the EITC are generally among the least able to comprehend the tax rules, yet they received nearly 75 percent of all combo letters in 2001. The IRS therefore runs the risk of appearing to follow two sets of procedures: sending two relatively clear letters to most taxpayers, and one truncated and confusing combo letter to low income taxpayers who are least likely to understand - and least likely to complain. Further, there are many cognitive learning studies that amply (and empirically) demonstrate that people absorb complex information in bits and through repetition.

The IRS plans to evaluate the results of its "pilot" on the basis of three success factors. None of these factors measure whether the taxpayer who received the letters actually understood what rights they were being offered. In order to evaluate the effectiveness of the letters, then, the IRS must conduct focus groups or a survey of taxpayers to determine whether the letter communicates its message to the taxpayer. What should be measured here is effective notice, not merely responsiveness.

Notice Clarity

The Wage and Investment Division has formed the EITC Notice Redesign Team to rewrite and improve letters issued through the RGS system and Publication 3498. At this time, however, no changes have been formalized. While the issues are still being discussed by the National Taxpayer Advocate and the senior management of the Division, there is still substantial resistance on the part of the IRS to discontinuing the use of combo letters.

There is also hesitation to include certain information in the letters that would assist taxpayers in the examination process, such as a telephone number for the specific tax examiner handling the case.

When the taxpayer attempts to reach the IRS at the number given to all taxpayers under audit by Correspondence Examination at a particular campus, he or she often has great difficulty in reaching the correct person needed to help resolve the problem. The assistor answering the telephone does not have the taxpayer's case, correspondence, or any documentation sent by the taxpayer, and is therefore unable to answer any specific questions the taxpayer may have. The assistor only has access to general information that may or may not be applicable to a particular taxpayer. The taxpayer may ultimately be transferred to the correct person; however, this process causes unneeded frustration and the use of time that could have been spent more productively, and in some cases, the taxpayer will not be transferred to the correct person.

ORAL REQUESTS FOR APPEALS

There continues to be no mention in combo letters that an oral request by the taxpayer for an Appeals conference is allowed by the Treasury Regulations in correspondence examination cases.[14] *The taxpayer is told only that he or she has the right to file an administrative appeal as explained in Publication 3498.*[15] *This publication does not include any mention that an oral request is permissible.*

Since taxpayers involved in correspondence examinations are often from lower socioeconomic levels of society, the burden of sending a written request and stating the reasons for disagreement may be a hurdle they cannot overcome. Consequently, it is reasonable to assume that many of these taxpayers fail to respond during the audit process simply because they lack the skills to do so, thus increasing the default rate, the number of incorrect assessments of tax, and unnecessary additional expenses to the IRS due to requests for audit reconsiderations and the involvement of Collection, Appeals and Counsel.

RECOMMENDATIONS

In order to remedy this problem and ensure that the IRS assesses the correct amount of tax in these cases, the National Taxpayer Advocate makes the following recommendations:

- *Discontinue the use of the combo letter and return to the previous procedure of using two letters - one, a preliminary audit report and the other, the traditional 30-Day Letter providing notice and explanation of appeal rights – in order to give the taxpayer a realistic amount of time to submit documentation and work with the examination unit to resolve the issues before issuance of the notice of deficiency.*

14 Treas. Reg. § 601.106(a)(1)(iii)(a).

15 Internal Revenue Service, *The Examination Process*, Publication 3498 (Revision 1-2003), p. 6.

- *Include the name and telephone number of the tax examiner handling the case in all correspondence.*
- *Make requests for substantiation as specific to the case as possible to prevent misunderstandings about what is being requested.*
- *Include a clear statement in the 30-day letter telling the taxpayer when the 30-day period for requesting an Appeals conference begins and ends.*
- *Include clear instructions regarding appeal rights (including the specific steps for requesting an appeals conference) in both the 30-Day Letter to the taxpayer and in Publication 3498 to ensure that there is no confusion or contradictory instructions, including the taxpayer's right to orally request an Appeals hearing both before and after the issuance of the notice of deficiency. These instructions should make clear that, if requesting an Appeals conference after issuance of the notice of deficiency, the 90-day period is running for the taxpayer to petition the Tax Court for a hearing of the case.*
- *Conduct a pilot in which the publication listing Low Income Tax Clinics (LITCs) is included with the initial contact letter to assist eligible taxpayers in receiving professional help in the audit process.*

PROBLEM
TOPIC #7 **MOST SERIOUS PROBLEM: OFFERS IN COMPROMISE**

RESPONSIBLE OFFICIAL

Dale Hart, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The Internal Revenue Service's administration of the Offer-in-Compromise (OIC) Program is a key indicator of the agency's commitment to fairness and equity in a tax system dependent on voluntary compliance. To ensure voluntary compliance, taxpayers must trust that the IRS exercises its powers and authorities wisely in administering an enormously complex tax code that even for tax professionals and IRS employees have difficulty understanding. In terms of absolute numbers, the OIC program is small, with 127,769 offers submitted in fiscal year 2003.[1] Yet it is one of the most visible programs to the American public, largely due to a cottage industry of practitioners who advertise on television and in newspapers that they can persuade the IRS to settle delinquent accounts for much less than the amount actually owed.

All taxpayers are expected to report their tax liabilities accurately and pay them timely. Each taxpayer should have the expectation that all other taxpayers are complying and paying, as the law requires. The Internal Revenue Code grants the Commissioner authority to compromise a tax liability for doubt as to liability, doubt as to collectibility, or in furtherance of effective tax administration (ETA).[2] In a few short paragraphs, IRS Policy Statement P-5-100 articulates how the OIC Program is to be used to ensure fairness and equity.[3] The OIC Program acknowledges that taxpayers, despite their best efforts to comply, may need to settle a tax debt in order to become fully compliant again.

[1] SB/SE, Executive Summary for IRS Oversight Board, October 2003

[2] IRC § 7122.

[3] Policy Statement P-5-100 provides:

> The Service will accept an offer in compromise when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential.
>
> An offer in compromise is a legitimate alternative to declaring a case currently not collectible or to a protracted installment agreement. The goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the Government.
>
> In cases where an offer in compromise appears to be a viable solution to a tax delinquency, the Service employee assigned the case will discuss the compromise alternative with the taxpayer and, when necessary, assist in preparing the required forms. The taxpayer will be responsible for initiating the first specific proposal for compromise.
>
> The success of the compromise program will be assured only if taxpayers make adequate compromise proposals consistent with their ability to pay and the Service makes prompt and reasonable decisions. Taxpayers are expected to provide reasonable documentation to verify their ability to pay.
>
> The ultimate goal is a compromise that is in the best interest of both the taxpayer and the Service. Acceptance of an adequate offer will also result in creating for the taxpayer an expectation of and a fresh start toward compliance with all future filing and payment requirements.

Because the OIC has limited application as a collection tool, its costs and benefits cannot be fairly compared to other collection alternatives. The payback for the agency's expenditures on the OIC program should not be weighed by the dollars collected alone, but also by the perception of taxpayers that their government can faithfully and fairly deliver on its mission to deliver world-class tax administration. The IRS, through its Small Business / Self-Employed (SB/SE) function, which administers the OIC program, has made significant advances and improvements over the past two years. However, there is still a long way to go before the IRS administers the program in accord with its policy statement.

ANALYSIS OF PROBLEM

Background

To its credit, IRS has taken positive steps to make its inventory of OIC cases current, and to help taxpayers and their representatives stay apprised of the status of their cases. SB/SE's year-end inventory of OIC cases for fiscal year 2003 totaled 65,327, a 13 percent reduction from the prior year.[4] For the same period, the percentage of offers closed within six months increased to 56 percent, up from 38 percent the prior year.

The inventory improvement was accomplished largely through implementation of the Centralized Offer In Compromise (COIC) Program at two IRS campuses, Memphis and Brookhaven. In FY 2003, 65 percent of all offers were worked by COIC, and 85 percent of cases closed in COIC were closed within six months. The National Taxpayer Advocate agrees with SB/SE that most OICs submitted by wage earners and out-of-business individuals under the "doubt as to collectibility" provision can be effectively worked in a centralized environment. She will continue to work with SB/SE in improving service and the quality of COIC determinations.

OIC Policy and Procedure

There remain, however, fundamental concerns about how the commitment to Policy Statement P-5-100 will be fulfilled. Collection employees obtain their procedural guidance from the Internal Revenue Manual (IRM).[5] Though the policy statement directs IRS to consider an OIC as an alternative to an extended installment agreement, the progression of guidance in the IRM directs the SB/SE employee to consider an offer only after determining that the taxpayer could not enter into an installment agreement by extending the statutory period for collection an additional five years. These procedures preclude many taxpayers from an opportunity for a fresh start toward compliance. We urge SB/SE to follow the intent of the policy statement and adopt IRM language that would require collection employees to consider and discuss an offer with the taxpayer prior to extending

[4] IRS Small Business/Self-Employed Operating Division, Executive Summary for IRS Oversight Board, October 2003.

[5] Internal Revenue Manual 5.8.

any statute for the purpose of securing an installment agreement. Current IRS procedures prohibit any installment agreement that does not provide for full payment of the liability during the remaining statutory period for collection.[6]

Evaluating the Offer: Reasonable Collection Potential (RCP)

To determine the viability of a "doubt as to collectibility" offer, the IRS uses a formula called reasonable collection potential (RCP). That formula is a combination of distrainable[7] equity in assets plus the amount that could be collected from installments over a five-year period. The RCP formula was devised as a way for the IRS to be consistent in its evaluation of offers and to communicate an expected basis for the OIC to the taxpayer and/or their representative. However, the IRM provides minimal guidance on how to weigh RCP with other factors such as the age and health of the taxpayer, the likelihood of bankruptcy, the likelihood of enforced collection, or time left on the collection statute.[8] According to correspondence TAS receives from taxpayers, the RCP formula too often constitutes the sole factor in the IRS's analysis of an acceptable offer. There is little evidence to the taxpayer that the IRS has considered anything but the cold, hard numbers. Moreover, TAS frequently receives complaints that the national standards for expenses are rigidly adhered to, without considering the taxpayer's individual circumstances.[9]

Under current procedures, SB/SE employees have to make a case with a written narrative for accepting an offer.[10] On the other hand, to reject an offer, the SB/SE employee is only required is send the proponent a "reject with options" letter with the computer generated RCP calculation and perhaps the optional sentence that, "we have considered the special circumstances you raised but they did not warrant a decision to accept your offer."[11] Employees need more guidance on how to weigh other factors with RCP, and on communicating their consideration of these factors and the decision to the proponent.

Unfortunately, many taxpayers have equity in assets that they cannot tap, such as in a personal residence, due to their inability to repay a loan on that property. Despite the unlikelihood that the IRS would ever enforce collection against a personal residence with marginal equity, OICs are rejected on the basis of equity in such assets. At the urging of the National Taxpayer Advocate, SB/SE has commenced a study with the assistance of the Office of Program Evaluation, Research, and Analysis (OPERA) to determine the col-

[6] Internal Revenue Manual 5.14.2.1.

[7] Distraint is defined as "to seize and hold (property) to compel payment or reparation, as of debts." Distrainable means "capable of being distrained." *The American Heritage Dictionary of the English Language, Fourth Edition, Houghton Mifflin Company*, 2000.

[8] Internal Revenue Manual 5.8.4.5.

[9] IRC § 7122(c)(2)(B) provides that "...officers and employees of the Internal Revenue Service shall determine on the basis of facts and circumstances of each taxpayer, whether the use of schedules published under subparagraph (A) is appropriate..."

[10] Internal Revenue Manual 5.8.8.2.

[11] Internal Revenue Manual 5.8.7.7(3).

lection activity on accounts for which offers were rejected because they did not meet RCP. It is hoped that the OPERA study will shed light on the validity of the current RCP formula and of using additional factors in accurately gauging true collection potential.

An emerging issue is the use of reverse mortgages as a remedy for the situation where an elderly taxpayer has equity in his or her personal residence but cannot afford to liquidate it. Reverse mortgages were initially conceived as a way for terminally ill individuals to tap into the equity in their residence to pay living expenses. In recent years, these mortgages have begun to be used for additional purposes. Reverse mortgages are generally available to individuals aged 62 or older, and have much higher interest rates and closing costs than traditional mortgages, as there is no requirement for repayment by monthly installments.[12] Although a taxpayer may elect to finance an OIC with a reverse mortgage, the IRS should not insist on such an arrangement to fund an OIC. In many cases, there may be a fine line between familiarizing taxpayers with, encouraging the use of, and mandating reverse mortgages. We also urge the IRS' Appeals function to adopt similar guidance. In two examples in a recent Appeals training video on ETA OICs, an Appeals officer asked the taxpayer to provide information on their attempt to secure a reverse mortgage, inferring that this was a prerequisite to ETA consideration.

When taxpayers submit an OIC on the basis of doubt as to collectabiltity or effective tax administration, they must submit a financial statement signed under penalty of perjury. Many taxpayers who submit OICs have little or no current income. Instructions in the IRM allow the SB/SE employee to change the amount of income if, in their judgment, the taxpayer's income is sporadic or likely to change.[13] This is an unacceptable shortcut. The answer to this dilemma is to insist on a future income collateral, a tool already provided for in the IRM.[14] However, SB/SE discourages the use of collateral agreements because they must be manually monitored for the life of the agreement.[15]

OIC Outcomes

We have continuously urged SB/SE to eliminate its "reject with options" letter.[16] This letter tells the taxpayer that his or her offer is being rejected and why (usually because it does not meet RCP). Although the taxpayer can continue to attempt to negotiate with SB/SE, the clock on petitioning for an appeal is already running. This process, which inherently discourages resolution of the accounts within SB/SE, is confusing for many taxpayers. Appeals inventory of OIC cases has increased 43 percent from 7,987 at the

[12] Federal Trade Commission Consumer Alert, "Reverse Mortgages - Cashing In On Home Ownership," available at http://www.ftc.gov/. More information available from the AARP Home Equity Information Center, 601 "E" St. N.W., Washington D.C 20040; or the National Center for Home Equity Conversion, 7343 147th St West, Suite 115, Apple Valley, MN 55124.

[13] Internal Revenue Manual 5.8.4(4).

[14] Internal Revenue Manual 5.8.6.3.1.

[15] Internal Revenue Manual 5.8.6.3(1) and IRM 5.8.6.3.1(6).

[16] The "reject with options" letter is a form of the "Combo" letter discussed herein at page 87.

beginning of FY 2003 to 11,385 at the end of the year.[17] It is likely that this increase, in whole or in part, is attributable to "protective" appeal requests and that some of these offers could have been resolved at the point of first contact. The importance of a clear opportunity to request an appeal is increased because the IRS is barred by statute from extending the 30-day period for appeal requests.

User Fee/Processability

On November 1, the IRS instituted a $150 user fee for offers in compromise.[18] Taxpayers with offers based on doubt as to liability or whose income is below 100 percent of the federal poverty level are exempted from the fee. Further, if an offer is accepted to promote effective tax administration, or is accepted based on doubt as to collectibility with a determination that collecting more than the amount offered would create an economic hardship, the fee will be applied to the amount of the offer or refunded.

The stated purposes of the user fee are to offset the processing costs of the OIC program and discourage inappropriate offers. In conversations with SB/SE, and in the 2002 Annual Report to Congress, TAS asked SB/SE to identify those OIC proponents who were submitting inappropriate offers and to conduct targeted outreach to modify that behavior. The Taxpayer Advocate Service also urged SB/SE to analyze the causes of offers being returned as unprocessable and to set objectives for reducing the number of OICs returned to proponents. We are disappointed that SB/SE has implemented neither of these proposed initiatives.

Nearly 24 percent of all OICs received are determined to be not processable by the IRS and returned to the proponent. Of the remaining OIC cases that are processable, about 46 percent are also returned because the taxpayer did not respond to SB/SE's request for additional information or for other compliance related issues (e.g. estimated tax payments, untimely federal tax deposits).[19] Approximately 12 percent of FY 2003 OIC TAS receipts were related to issues concerning missing information or information not received by the SB/SE deadlines.[20]

The IRS has now incorporated the user fee into its "processability" determination. The proposed regulation published for public comment said, "Currently, an offer is returned as nonprocessable if the taxpayer is in bankruptcy, has not filed required tax returns, or has not perfected the offer by properly preparing the offer to compromise form *and submitting other required documents*.[21] When the final regulations were adopted, this italicized

[17] Per Director of Appeals Tax Policy and Procedure.

[18] 68 Fed. Reg. 48785; Treas. Dec. Int. Rev. 9086; August 15, 2003.

[19] IRS, Small Business/Self-Employed Operating Division, Executive Summary for IRS Oversight Board, October 2003.

[20] Taxpayer Advocate Management Information System (TAMIS) Database, Case Criteria 7 and 9.

[21] 67 Fed. Reg. 67573, November 6, 2002, p. 2.

phrase was omitted.[22] This change has been interpreted to mean that if the OIC meets the other tests but the taxpayer fails to provide all of the supporting information requested by IRS, the offer will be returned without appeal rights, and without returning the $150 user fee.

SB/SE has drafted internal guidelines to waive fees on resubmission when it determines that the previous offer was returned in error or the taxpayer demonstrates circumstances beyond their control and not mere negligence or unavoidable delay. Nonetheless, the IRS should not have it both ways. It should return the user fee when it returns an offer as unprocessable because of insufficient documentation; or, it should retain the user fee, reject the offer on the basis of insufficient documentation, and grant the taxpayer appeal rights.

Customer Satisfaction

Treasury Regulation 801, which took effect on September 7, 1999, required the IRS to establish customer satisfaction measures with respect to the OIC program.[23] However, SB/SE has only technically met the requirements of the regulation. Polling conducted for SB/SE applies to all its customers. Lumping diverse programs such as levies, installment agreement and OICs together does not lead to actionable results. However, other stakeholders such as the American Institute of Certified Public Accountants (AICPA) have conducted their own surveys and concluded that the IRS needs demonstrative action "to counter the perception that it does not favor OICs."[24]

SB/SE Improvement Efforts

Of positive note are SB/SE efforts to improve on the quality of its casework. We again urge SB/SE to incorporate its handbook/desk guide procedures into its IRM, particularly as a complete revision to the field IRM is underway. The Taxpayer Advocate Service has provided comments to SB/SE on changes it would like to see in the field IRM. These changes include, but are not limited to, additional guidance on:

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[22] 68 Fed. Reg. 48785, August 15, 2003, p. 2.

[23] Section 801.4 requires IRS to establish customer satisfaction measures via various methods. For example, questionnaires, surveys and other types of information gathering mechanisms may be employed to gather data regarding customer satisfaction. Information to measure customer satisfaction for a particular work unit will be gathered from a statistically valid sample of the customers served by that operating unit and will be used to measure, among other things, whether those customers believe that they received courteous, timely and professional treatment by the IRS personnel with whom they dealt.

[24] "Based on concerns expressed by many of our members, we fear that IRS employees at the COIC sites might be reducing OIC inventory levels based on implementation of rigid procedures; tight rules regarding what constitutes a "processable" offer and short time frames for submitting updated or missing documents. The respondents who believe training is inadequate emphasized their impression that COIC employees review OICs in a mechanical fashion without giving any meaningful thought or consideration to the unique circumstances of each individual case. These respondents seem to believe that the COIC employees find it easier to reject the Offer as opposed to finding reasons to accept it." Letter from Robert A. Zarzar, Chair, Tax Executive Committee, AICPA, to Dale Hart, Commissioner, IRS Small Business/ Self-Employed Operating Division, (October 14, 2003), reprinted in 2003 TNT 200-38.

- the consideration of special circumstances,
- the probability of enforcing collection within the remaining statute, and
- the use of collateral agreements.

In her 2002 Report to Congress, the National Taxpayer Advocate commented on less than favorable results from SB/SE's centralized quality review.[25] Later this fiscal year, COIC casework will become subject to "embedded" quality review that will tie case performance to employee performance appraisals. This program will more than double the amount of cases subject to the current quality review. It will also ensure employee accountability for performance. We commend SB/SE for their work on this initiative.

SB/SE continues to improve the OIC website, available at http://www.irs.gov/businesses. This site contains user-friendly information on the types of offers, how and where to file them, forms, required documentation and frequently asked questions. The SB/SE function is aware that Form 656, Offer in Compromise, is in critical need of revision to include information on the policy statement, ETA offers, user fees, extension of the statutory period for collection, and financing an OIC. Much of the web site information will be incorporated into a revised Form 656 to be issued later in 2004. In August 2003, IRS' Taxpayer Education and Communication (TEC) agreed to provide subject matter experts for general outreach and education on OICs. In addition to this general outreach, working actively with groups such as the IRS Advisory Committee (IRSAC), and its annual outreach at the IRS Tax Forums, we continue to recommend targeted outreach to reduce the number of OICs that the IRS returns to proponents.

At the suggestion of the National Taxpayer Advocate, SB/SE formed a specialty group in June 2003 to consider all new non-hardship ETA offers.[26] Specifically, these are OICs submitted on the basis of equitable or public policy considerations. In such offers the taxpayer must demonstrate why he or she should be relieved of part of a liability that is both due and collectable, while all other taxpayers must pay their liabilities in full. In addition to working new receipts, this group will become subject matter experts on these cases for other OIC field examiners and COIC offer examiners. After cases worked by this group are closed, a high level cross-functional group will look at examples and outcomes to further clarify the scope of the new ETA regulations.

IRS COMMENTS

The Offer-in-Compromise (OIC) program in fiscal year (FY) 2003 was characterized by continued improvement, building on program changes that were implemented in the prior two years. Most notably, the Centralized Offer-in-Compromise (COIC) processing

[25] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 22.

[26] Treas. Reg. 301.7122-1 provides taxpayers with exceptional circumstances, an opportunity for compromise when they cannot qualify under hardship, doubt as to collectibility, or doubt as to liability.

sites in Brookhaven and Memphis continued to mature as organizations, taking on more responsibility for the overall OIC program. Since the COIC sites became operational in October 2001, we have seen significant improvements in the timeliness of OIC dispositions, and the overall age of the inventory of open OIC cases. The overall inventory of open OICs as of September 2003 stood at 65,334, compared to 92,060 in October 2001 - a 29 percent reduction. Open OICs assigned to the Field were reduced 55 percent during that same period. The currency of the open OIC inventory also improved significantly during this period. At the conclusion of FY 2003, over 95 percent of the active COIC inventory had aged six months or less. Cases assigned to the Field for 12 months or longer were reduced by 38 percent compared to April 2002, and inventory backlogs in the OIC field program are almost completely eliminated. As a result, during the final quarter of FY 2003, approximately 61 percent of all processable OIC dispositions were resolved in six months or less - a 97 percent improvement since October 2001. We continue to modify the OIC process in order to improve the quality of case decisions and the levels of service we provide to taxpayers seeking to compromise their tax liabilities, particularly in our COIC operations.

The IRS supports the policy that the OIC is a legitimate collection alternative in situations where the tax liability is not likely to be collected in full, and the offer reasonably reflects collection potential. However, the OIC should not be considered as the optimum payment method of choice in all situations. To ensure that this message is clearly understood, the IRS devoted a considerable amount of time and attention in FY 2003 to outreach activities. These efforts were designed to increase the public's awareness of the proper role of the OIC as a collection alternative, as well as to explain the requirements for taxpayers to submit processable OICs that can be evaluated and resolved in a timely manner. As part of this effort, the OIC page of the IRS "Digital Daily" web site has been updated to provide a comprehensive explanation to the public of the OIC submission requirements. The "Digital Daily" is now much easier to navigate and the OIC information much easier to find. IRS executives and senior managers have also participated in numerous outreach sessions specifically addressing the OIC program, including the National Tax Forums and the web-based Tax Talk Today. The IRS continues to work closely with tax practitioner organizations through the Internal Revenue Service Advisory Committee (IRSAC), which has established a standing sub-group devoted entirely to the OIC program. This group meets regularly to discuss and provide feedback on issues pertaining to the OIC program.

OIC Policy and Procedures

We concur with the National Taxpayer Advocate that some clarification may be needed to ensure consistent interpretation of policy statement P-5-100. Specifically, the term "protracted installment agreement" appears to be a source of confusion and disagreement, and warrants clarification. Prior to the implementation of RRA 98, it was not uncommon for the IRS to require waivers from taxpayers entering into installment agreements that extended the collection statute (CSED) for 10 years or longer. These "protracted installment agreements" in some cases represented agreements that would never be fully paid due to the accrual of penalties and interest. In order to address this problem, the IRS defined a reasonable term for any installment agreement to be the time remaining on the CSED, plus five years. Absent "special circumstances" that warrant consideration of an Effective Tax Administration (ETA) offer, if a taxpayer can fully pay the tax liability within this timeframe, and offers less through an OIC, the IRS does not believe that the offer is "in the best interest of both the taxpayer and the Government", which is another key component of P-5-100. We believe this distinction is not clearly understood, both internally and externally, and will clarify this position in the Internal Revenue Manual and in our external outreach materials.

Evaluating the Offer: Reasonable Collection Potential (RCP)

P-5-100 states that an acceptable offer amount "reasonably reflects collection potential" and that "taxpayers make adequate compromise proposals consistent with their ability to pay." A common complaint associated with the OIC program in the past was the perception that OIC personnel were not consistent in evaluating OIC applications to determine reasonable collection potential. Consistency in application is a critical prerequisite to maintaining integrity and equity in the OIC program. As a result of this feedback, the IRS developed the national and local standards for "allowable expenses" used in evaluating requests for OICs. While these national and local standards are used as part of the RCP analysis, the IRS does recognize that there are situations where the RCP alone does not reflect the taxpayer's true ability to pay. Occasionally, special circumstances exist that warrant consideration and may result in accepting offers that are less than what the routine RCP analysis would require. Our employees have been trained to look at all facts surrounding the OIC request and we continue to reinforce that they can and should deviate from the national standards when the taxpayer's individual circumstances make it appropriate to do so. This guidance is currently included in the IRM and will be reemphasized in an upcoming revision. We are working closely with both the Office of NTA and the AICPA to identify specific case examples where deviation was warranted but not allowed by our employees so that we can better target training and communication efforts for employees.

We agree with the National Taxpayer Advocate regarding the need to conduct an analysis of the ultimate outcomes of OICs that have been rejected or returned. Working with the Office of Program Evaluation, Research and Analysis (OPERA), we have determined that there are no discernable demographic factors that influence situations where OICs need to be returned. Consequently, we have designed our outreach efforts to reach as broad an audience as possible. In addition to the significant outreach efforts mentioned earlier, we are currently in the process of soliciting input from external stakeholders, such as the American Institute of Certified Public Accountants (AICPA) or the Information Reporting Program Advisory Committee (IRPAC), as well as the National Taxpayer Advocate to assist in making our next revision of the OIC application package, Form 656, as clear and understandable as possible. A goal of this revision is to reduce the number of OICs that need to be returned due to missing or incomplete information, as well as more clearly identify the criteria for processable offers.

We also agree that more IRM direction on issues such as reverse mortgages, how to consider the potential for bankruptcy, and collateral agreements would be helpful for OIC personnel in evaluating OICs, in appropriate situations where these issues may arise. The next revision of the IRM will address these issues.

OIC Outcomes

We share the Advocate's concerns with the relationship between the use of the "reject with options" letter and the increase in the number of appeals resulting from the COIC rejection decisions. To reduce the problem we have recently decided to alter the OIC rejection process, and provide a preliminary determination letter to the taxpayer for the majority of proposed OIC rejections. This letter will give the taxpayer an opportunity to communicate with the IRS regarding the proposed rejection decisions without starting the clock on petitioning for an appeal. If the additional communication does not result in an accepted offer, the taxpayers will receive the "reject with options" letter, which will provide the opportunity to formally appeal the rejection decisions.

User Fee/Processability

Despite the significant improvements in overall efficiency of the OIC program, the costs associated with the administration of the program remain disproportionately high. In order to offset a portion of these costs, the IRS implemented a $150 OIC Application Fee in November 2003. For those taxpayers who submit a "non-processable" offer, the IRS will return application fees since IRS resources and associated costs are minimal.

However, once the OIC has been accepted for processing, the associated costs increase substantially. At that point IRS personnel evaluate the OIC applications, identify missing (but necessary) information, make determinations regarding additional information required to make a final case decisions, correspond with the taxpayer, evaluate taxpayer responses, and formally close the offers. If, however, taxpayers do not submit the requested documentation during the process to support their offers, the offer is ultimately not accepted. As noted, the costs for this stage of the process are high whether or not the offer is accepted or not and, for this reason, the IRS does not agree with the Advocate's position that the $150 OIC application should be returned.

As the Advocate acknowledges in this report, a large percentage of taxpayers requesting OIC consideration do not respond adequately to requests for information. In FY 2003, 46 percent of the processable OIC dispositions fell into the category of "processable returns." IRS fully acknowledges that retaining the fees in these situations heightens the importance that our decisions to return offers are accurate and warranted. To this end we have developed procedures that will allow OIC personnel to waive the fee in situations where circumstances beyond the taxpayers' control were the cause of the delays. We have also increased our quality control expectations in this area. Recognizing the potential sensitivity of this issue, we worked closely with stakeholders, including the Internal Revenue Service Advisory Council (IRSAC) and National Taxpayer Advocate to develop the application fee and discussed all aspects of the proposal during public hearings prior to implementation.

TAXPAYER ADVOCATE SERVICE COMMENTS

The Internal Revenue Service should take pride in the accomplishments of SB/SE in improving the Offer-in-Compromise operation, in particular the improvement in timely determinations. A recent report by the Treasury Inspector General for Tax Administration (TIGTA) highlighted improvements in quality that affirm that SB/SE is making efforts in the right direction.[27] *The National Taxpayer Advocate recently visited the Memphis COIC site as a follow-up to a visit 18 months earlier and met with a local management team that is clearly committed to improving the quality of their operation. The OIC program has also benefited from placing an executive in charge of all OIC operations. In addition, the National Taxpayer Advocate is appreciative of the ongoing opportunity to consult with SB/SE concerning their operations and procedures.*

In the interest of taxpayers with pending offers, we would like SB/SE to make prompt and quality offer determinations. Although SB/SE has been unable to identify a discernable demographic for taxpayers whose offers need to be returned, we reiterate our recommendation to identify noncompliant

[27] Treasury Inspector General for Tax Administration, *Continued Progress is Needed to Improve the Centralized Offer-in-Compromise Process,* Reference # 200230028, July 24, 2003.

practitioners and to take proactive efforts to help them file processable offers. We would like SB/SE to gather customer satisfaction data that is specific for the OIC program and that can be acted upon to better meet customer expectations. We look forward to the OPERA report that will provide data related to the accuracy of the RCP formula. We appreciate that SB/SE requested and received TAS' input on a revised Form 656 and a revised Internal Revenue Manual (IRM). Proposed changes will provide offer proponents with better guidance on what to submit, and provide IRS employees with better guidance on technical issues such as self-employment income, reverse mortgages and future income collaterals. We also agree with the SB/SE commitment to consistency in the interest of fairness and customer expectations. The national expense standards are guidelines and offer examiners need to be alert for special circumstances leading to a fair negotiation of the offer amount. We are very pleased that SB/SE has agreed to reiterate and reemphasize guidance on the expense standards in the new IRM revision.

In its comments, SB/SE discussed the common misperceptions about the OIC program. The National Taxpayer Advocate takes the position that reiterating commitment to Policy Statement P-1-500 may help to clarify such misperceptions. We do not expect the IRS to accept offers that are not in the best interest of the government and the taxpayer. Further, we share their commitment to fairness for all taxpayers, and particularly to those who voluntarily comply by reporting the correct amount of tax and paying it timely. We agree with SB/SE's comment that "the OIC should not be considered as the optimum payment method of choice in all situations." Internal Revenue Code section 7122 was designed as an exception to a tax code and policy that requires payment of the full amount owed.

The Policy Statement talks about offers as an acceptable alternative to a "protracted installment agreement." SB/SE's position is that this term meant something different prior to the restrictions on waivers imposed by the IRS Reform and Restructuring Act of 1998 (RRA 98).[28] *The purpose of the RRA 98 provision was to prevent abusive waivers that were contrary to the intent of a statute of limitations period for collection. The legislation did not restrict the applicability of offers in compromise, nor did it change P-5-100. A lengthy installment agreement has an inherently higher opportunity to default than a shorter agreement, and the total amount of repayment is far from guaranteed. We look forward to the results of SBSE's joint study with OPERA on the eventual collection outcomes of rejected offers. Under the right circumstances, an offer can provide the taxpayer a much-needed fresh start toward future compliance, and with contractual certainty. In addition, the IRS has the right to request a collateral agreement if there are indications that the taxpayer's earnings are likely to improve. At minimum, we ask that the IRM require a discussion of an offer-in-compromise prior to*

[28] IRS Restructuring and Reform Act of 1998, Pub. L. No 105-206, § 3461.

extending statutory collection period by waiver, and that additional consideration can be given to the likelihood of the proposed installment agreement's default.

Both the IRS and the National Taxpayer Advocate agree that it is desirable to reduce the number of offers that are returned to taxpayers. It is the methods to best accomplish this on which we disagree. We previously recommended a more targeted approach, specifically toward large volume practitioners with high incidence of such returns. The IRS opted for a broader approach, adopting regulations to implement a user fee in hopes of modifying the behavior of the offer proponents.

SB/SE decided that the applicability of the user fee to a particular offer would be part of the "processability" determination. However, the concept of processability is difficult to understand as written in the regulation itself, particularly due to the phrase "returned as nonprocessable after acceptance for processing."[29] *The IRS processability criteria are fairly objective; that the offer is signed and submitted on the current form, that the taxpayer is not in bankruptcy and is in current compliance.*[30] *A subsequently issued revenue proclamation clarified IRS intention to also keep the user fee when the taxpayer fails to provide necessary documentation.* [31]

In response to public input on the proposed fee, IRS added a clause to the regulations, which would waive a subsequent fee if the Service determines that the original offer was rejected in error or returned in error after acceptance for processing.[32] *SB/SE has developed internal guidance to waive the fee when circumstances beyond the taxpayer's control were the cause of the delays. In addition, they have pledged to work with stakeholders including the Low Income Tax Clinics to successfully implement the user fee regulations.*

The National Taxpayer Advocate is not recommending that the IRS refund a user fee after it has invested resources into processing a case. She is, however, requiring the IRS to be logically consistent in its procedures. If a taxpayer's offer does not meet the "processability" criteria in the regulations, the IRS can return the offer (without appeal rights) along with the use fee. This is justifiable because the IRS has not invested significant time and energy in reviewing the offer.

[29] 68 FR 48785: Treas. Dec. Int. Rev. 9086 August 15, 2003, Page 6. ""(3) Except as otherwise provided in this paragraph (b), the fee will not be refunded to the taxpayer if the offer is accepted, rejected, withdrawn, or returned as nonprocessable after acceptance for processing."

[30] 68 FR 48785: Treas. Dec. Int. Rev. 9086, August 15, 2003, Page 2. "Currently, an offer is returned as nonprocessable if the taxpayer is in bankruptcy, has not filed required tax returns, or has not perfected the offer by properly preparing the offer to compromise form."

[31] Rev. Proc. 2003-71. Section 5.04, September 8, 2003 "If an offer to compromise does not contain sufficient information to evaluate whether the offer should be accepted, the Service will request that the taxpayer provide the needed additional information...If the taxpayer does not submit the additional information that the Service has requested within a reasonable period of time after such a request, the Service may return the offer to the taxpayer...When an offer is returned under Section 5.04, the Service will not refund the application fee submitted with the offer unless the offer was accepted for processing in error."

[32] Treasury Regulation FR 48785: Treas. Dec. Int. Rev. 9086, August 15, 2003, Page 6. "(4) No additional fee will be charged if a taxpayer resubmits an offer the Secretary determines to have been rejected in error or returned in error after acceptance for processing."

Where a taxpayer's offer survives the processability stage, however, the IRS has begun to work it. Whether the IRS invests one hour, eight hours, or two weeks in time of working an offer, the taxpayer has crossed a processing threshold. Regardless of whether that taxpayer has failed to respond to the first request for information or the seventh such request, the offer should be rejected with appeal rights and the user fee retained.

We are very pleased to hear SB/SE's decision on the pre-determination letter. This will give the taxpayer a final chance to seek an administrative solution prior to resorting to Appeals. This will also minimize confusion on the part of the taxpayer as to whether there still remains an opportunity for dialogue with SB/SE. This decision also indicates SB/SE's willingness to consider input from the Taxpayer Advocate and other stakeholders for continued improvement of the offer process.

It has recently come to the attention of the National Taxpayer Advocate, through conversations with practitioners and professional organizations, that some practitioners are no longer attempting to proactively resolve their clients' cases by filing offers-in-compromise and are instead waiting to submit an offer in the context of a Collection Due Process hearing. Proponents of this approach justify this approach for the following reasons:

- *they can obtain face-to-face hearing with the Appeals Officer;*
- *they do not have to resubmit financial information because of lapse of time; and*
- *the Appeals Officer needs to close the case and so will be more "flexible" in his or her review.*

The National Taxpayer Advocate is concerned about this practice trend and will be addressing it in discussion with practitioner groups over the next year.

In many respects, the Offer-in-Compromise program has been a model for dialogue between the National Taxpayer Advocate and an operating function of the Internal Revenue Service. We look forward to continuing this relationship, furthering our mutual objective of world class tax administration.

PROBLEM

TOPIC #8 MOST SERIOUS PROBLEM: MATH ERROR AUTHORITY

RESPONSIBLE OFFICIALS

Henry O. Lamar, Commissioner, Wage and Investment Division
Dale Hart, Commissioner, Small Business/Self-Employed Division

DEFINITION OF THE PROBLEM

The Internal Revenue Service may summarily assess a tax, interest, and penalties when mathematical or clerical errors have been identified.[1] This "math error" authority described in Internal Revenue Code section 6213(b) has been applied to a growing list of adjustments that are not based on flawed math or transcription errors. Math error and summary assessment authority now covers 14 error categories, including the determination of who is a custodial parent for certain tax benefits.[2] The procedures for seeking abatements of math error assessments are strictly limited and poorly communicated to taxpayers.[3] The continued expansion of math error authority combined with limited, poorly communicated procedural rights can lead to incorrect assessments, administrative re-work, and even denial of taxpayer access to United States Tax Court.[4]

The 2002 National Taxpayer Advocate's Annual Report to Congress identified several problems with the IRS' current implementation of math error authority.[5]

- Math Error notices are confusing and offer inadequate explanations about the items that the IRS modified or denied on taxpayers' returns.[6]
- Taxpayers have difficulty reconciling the adjustments with their originally filed tax returns.[7]
- Taxpayers are not sure how to correct or challenge the notices, nor do they understand their right to challenge them.[8]

ANALYSIS OF PROBLEM

New Developments

This section is a follow-up report to review changes the IRS has implemented and how effectively those changes have addressed TAS concerns about math error authority. In its response to the National Taxpayer Advocate's 2002 Report, the IRS stated that it has initi-

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[1] IRC § 6213.

[2] IRC § 6213(g)(2).

[3] Robert B. Nadler, "Math Error Notices: In Search of Taxpayer Rights," Tax Notes Today. July 7, 2003, TNT 131-6: p. 2.

[4] National Taxpayer Advocate, *Annual Report to Congress,* Publication 2104 (Rev. 12-2002), p. 185.

[5] Id. p. 25.

[6] Id.

[7] Id.

[8] Id.

ated both short and long-term projects designed to improve taxpayer correspondence and math error authority procedures[9] These initiatives include:

- Redesign of notices to improve clarity;
- Revision of "math error codes" to simplify the procedure for employees to choose the correct code to correspond to a particular taxpayer's situation;[10] and
- Re-sequencing of math error codes to correspond to specific sections of the tax return.

Tables 1.8.1 and 1.8.2 summarize the status of IRS efforts. The National Taxpayer Advocate supports the IRS in its efforts to finally address many of the problems associated with math error authority. We are particularly pleased that math error notices issued during the 2004 filing season will include specific tax return line references for adjustments.

TABLE 1.8.1, ADMINISTRATIVE PROPOSALS & IRS SHORT TERM INITIATIVES

Administrative Proposals	IRS Initiatives	Status
Revise math error notices to include specific line-item numbers from the applicable tax return.	Redesign notices to improve clarity.	Notice Process Improvement Initiative Team (NPIIT) created to improve clarity of notices.
	Revise math error notices to include specific line-item numbers	NPIIT revised 61 Taxpayer Notice Codes (TPNCs) to include line specific references.[11] These improvements will be in place for Filing Year 2004 (Processing of Tax Year 2003 returns).
	Re-sequence notice codes for Error Correction processing to correspond to the tax return.	NPIIT Phase II completed this initiative. Scheduled for Filing Year 2004 implementation.
	Simplify math error codes to make it easier for employees to choose the correct code for each taxpayer's situation.	NPIIT eliminated 111 obsolete and duplicate TPNCs from the original list of 492, a 23 percent reduction in the list of notice codes employees must select from.[12] Scheduled for Filing Year 2004 implementation.
Improve training and guidance that is provided to all employees handling math error responses.	Improve training for IRS employees.	IRS is continuing to expand and improve guidance for employees handling math error cases, also incorporating improvements suggested by TAS and other external stakeholders.

[9] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Revision 12-2002), p. 29.

[10] Definitions: The term "Taxpayer Notice Codes" (TPNC) which appears in Table 1.8.1 includes both "Math Error Notice Codes" and "Non-Math Error Notice Codes." "Math Error Notice Codes" is often expressed simply as "Math Error Codes."

[11] NPIIT Final Report (61 notices revised from a total of 387 notice codes, equals 16 percent (61 divided by 387).

[12] NPIIT Final Report (492 total TPNCs reduced by 111 TPNCs equals a 23 percent reduction).

TABLE 1.8.2 ADMINISTRATIVE PROPOSALS & IRS LONG TERM INITIATIVES

Administrative Proposals	IRS Initiatives	Status
Revise math error notices to include specific line-item numbers from the applicable tax return.	Review all notices to eliminate obsolete or redundant notices.	IRS created Notice Elimination Notice Process Improvement Initiative Team (NE-NPIIT) to review all notices. Improvements are scheduled for Filing Year 2005 (Processing of Tax Year 2004 returns).
	Revise abatement and appeal rights language to make them more understandable for taxpayers.	Phase III NPIIT reconvened in October 2003 to revise the abatement and appeal rights language on all math error notices for FY 2005 implementation.
	Make all math error codes line item specific, if applicable.	The Phase III NPIIT revised the remaining math error codes to include line-specific item references. Revision scheduled for July 2004 implementation.
	Create a template for all notices to ensure notices are consistent.	Established a Notice Standardization Team to create a template for all IRS notices. Template is to be used to ensure notices include all necessary elements and are reader-friendly. Undetermined implementation.
	Include recommendations received from external stakeholders to improve notice language.	Input on the revised notices received from several sources (Taxpayer Advocacy Panels, Low-Income Tax Clinics, and comments solicited from taxpayers). Final revision of the Taxpayer Notice Codes (TPNCs) incorporated many responses, including recurring comment to customize TPNCs to describe the specific error on the return. Results scheduled for implementation for July 2004.
Track abatements using a management information system.	Study methods to track abatements.	Study in process. IRS will consider results in deciding whether to pursue development of an abatement tracking system. Undetermined implementation date.

The possible loss of access to administrative abatement, appeal, and judicial review remains a serious issue that is of particular concern to the National Taxpayer Advocate. If a taxpayer timely requests an abatement of tax, the IRS is obligated to make the adjustment, and to make any reassessment through audit deficiency procedures.[13] Unless the taxpayer proactively requests abatement and is granted entry into audit deficiency procedures, the right to petition the United States Tax Court in a deficiency proceeding is lost. This is the only pre-payment tax judicial forum.[14]

The National Taxpayer Advocate remains concerned that math error authority as currently administered deprives taxpayers of their right to administrative appeal and judicial review as provided for in Internal Revenue Code section 6213.[15] The Service must provide clear guidance to taxpayers about their right to request abatement of a math error adjustment. She recognizes that this issue requires a multi-step approach. Revising the abatement and appeal rights language in the math error notices is a first step. The IRS must supplement these efforts by placing additional emphasis on ensuring that taxpayers understand these rights.

LEGISLATIVE RECOMMENDATIONS

In her 2002 Annual Report to Congress, the National Taxpayer Advocate outlined specific criteria for any expansion of math error authority granted to the IRS under Internal Revenue Code section 6213(g). Math error assessments should be limited to the following situations:

- Inconsistent items in which the inconsistency is determined from the face of the return;
- Omitted items, including schedules, that are required to be included with the return; and
- Items reported on the return that are numerical or quantitative and which can be verified by a government entity that issues or calculates such information.

The IRS prepared a position paper in response to this legislative recommendation. Table 1.8.3 summarizes the IRS' response to the National Taxpayer Advocate's Legislative Recommendations:

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[13] IRC § 6213(b).

[14] IRC § 6213(b); *See* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Revision 12-2002), p. 26.

[15] IRC § 6213(b).

TABLE 1.8.3, LEGISLATIVE PROPOSALS AND IRS POSITION

Legislative Proposals	IRS Position
Limit the definition of mathematical and clerical error to: • Inconsistent items in which the inconsistency is determined from the face of the return; • Omitted items, including schedules, that are required to be included with the return; and • Items reported on the return that are numerical or quantitative and which can be verified by a government entity that issues or calculates such information.[16]	• Use of math error procedures does not lessen taxpayer rights. • Taxpayers who potentially lose rights include those who make no response to math error notices. • Use of a statutory notice of deficiency after delivery of the first IRS notice will not increase the likelihood of taxpayer response.
Repeal the authority allowing the use of math error procedures for adjusting Earned Income Tax Credit (EITC) based on Federal Case Registry of Child Support Orders (FCR) information, since issues such as a child's place of residence are based on a facts and circumstances analysis.[17]	• The math error process allows IRS to resolve many EITC-related discrepancies with single-notice correspondence, rather than the more lengthy and expensive three-step deficiency process. • Use of statutory procedures for assessing additional tax as outlined in IRC § 6212(a), would require more resources to handle the same number of cases that are currently being resolved using math error procedures.[18]

IRS COMMENTS

The IRS agrees with the National Taxpayer Advocate that improvements in Math Error notice clarity need to be made. Many times taxpayers find the notices explaining the Math Error and Appeal processes to be confusing. In some cases, these notices offer inadequate explanations regarding items that the IRS modified or denied on tax returns and/or don't clearly explain the process of making an appeal. The IRS is committed to ensuring that every taxpayer understands our processes and his or her rights. To achieve that goal, we have created ongoing teams for notice improvement, resulting in:

- Revision of all business and some individual Taxpayer Notice Codes (TPNCs) to include line-specific references by January 2004. This improvement will be in time for the processing of Tax Year (TY) 2003 returns - not after most have already been processed, as stated by the Taxpayer Advocate.

[16] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Revision 12-2002), p. 186-187.

[17] Id.

[18] IRC § 6212(a) provides that,"[i]n general, if the Secretary determines that there is a deficiency in respect of any tax imposed by subtitle A or B or chapter 41, 42, 43 or 44, he is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail. Such notice shall include a notice to the taxpayer of the taxpayer's right to contact a local office of the taxpayer advocate and the location and phone number of the appropriate office."

- Start-up of a standardized language notice team in January 2004.
- Scheduled revision of the remainder of the individual math error codes with line-specific item references by July 2004.
- Incorporation of stakeholder recommendations on improved language by July 2004.
- Implementation of changes in notice language on Appeals by January 2005. We recognize the importance of this effort and will make every effort to ensure timely implementation.
- Elimination of obsolete or redundant notices by January 2005. This will ensure the reduction of confusion on the part of both taxpayers and employees.

The IRS does not agree that the current Math Error program deprives taxpayers of their right to administrative appeal and judicial review. Internal Revenue Code section 6213(b) authorizes the IRS to assess an amount of tax in excess of that shown on the return if the excess is the result of a mathematical or clerical error appearing on the return. To do so, the IRS must send a notice to the taxpayer identifying alleged error with an explanation. If the taxpayer disagrees with the assessment and requests an abatement of this amount, the IRS is required to abate the tax. Any reassessment of such tax is subject to the deficiency procedures that would afford the taxpayer opportunity to obtain judicial review before the tax is reassessed. In addition, if the taxpayer does not request an abatement within the prescribed 60-day timeframe, the opportunity to file a claim for refund provides another avenue for taxpayers to appeal the assessment and/or seek judicial review. However, we feel that increased clarity of notices will help taxpayers understand their already adequate rights in this area.

In the IRS view, the use of math error procedures does not lessen taxpayer rights. Potentially lost rights, according to the National Taxpayer Advocate in her 2002 Report to Congress, included situations where taxpayers make no response to IRS math error notices and, thereby, lose their opportunity to petition the Tax Court. IRS does not believe, and the Advocate has not presented any data to support, that a taxpayer is more likely to respond to a statutory notice of deficiency after receiving a first IRS notice than their responding to a math error notice.

In May 2003, the IRS and Office of Chief Counsel advised Treasury that we did not support the Taxpayer Advocate's effort to rescind certain aspects of the Math Error authority. Administration of this authority reflects the Congressional intent authorizing the IRS to dispose of taxpayer errors without resorting to examination deficiency procedures. This authority, clearly defined in the Internal Revenue Code (IRC) 6213(g), allows the IRS to prevent issuance of erroneous or fraudulent refunds when taxpayers' returns contain the enumerated missing or incorrect entries, reduces taxpayer burden in many cases and focuses limited IRS resources on other customer service efforts.

The IRS continues to disagree with repealing the use of math error procedures for adjusting EITC based on Federal Case Registry of Child Support Orders (FCRCSO) information. The FCRCSO is a government database that includes child support orders. A child support order is part of a divorce decree stating with whom the child resides. Access to these orders allows the IRS to determine whether a taxpayer is a custodial parent and, thus, entitled to the Earned Income Tax Credit (EITC). Use of the FCRCSO is akin to obtaining information from SSA to determine the age of a taxpayer and therefore, whether the taxpayer is entitled to the credit for the elderly. Another example would be obtaining information from the Form 1098, which supports the deduction for mortgage interest paid, in the same way that as a child support order supports the residency requirement for eligibility for the EITC. It should also be noted that the sharing and use of government databases between agencies is consistent with the e-government initiative of the President's Management Agenda.

To ensure that FCRSCO is an appropriate source of information for math error contacts, a task force that includes representatives from the Taxpayer Advocate Service is currently working to perfect the FCRCSO database as well as the IRS processes for interacting with the database. Based on these efforts so far, IRS has some concerns and has delayed implementation of expanded math error authority using FCRCSO for processing year 2004, and will continue to study the use of this data to preclude duplicate or fraudulent claims of qualifying dependents by non-custodial parents for purposes of the EITC. Once this study is complete, a decision will be made on the use of this expanded math error authority in a subsequent year.

TAXPAYER ADVOCATE SERVICE COMMENTS

The IRS has taken numerous, positive steps to improve the communication of taxpayer errors and proposed corrections. We are pleased to have had a Taxpayer Advocate Service analyst serving on the Notice Process Improvement Initiative Team (NPIIT) and look forward to observing the effect of math error notice revisions during the processing of 2003 tax returns. We reemphasize the need for an ongoing, systemic review process to assess the effectiveness of the revised notices as well as the error identification process itself.

We continue to assert that inappropriate use of the math error process does abridge taxpayer appeal rights in several important ways. First math error notices fail to disclose the significance of an insufficient response. The IRS implies that the same taxpayers who fail to respond to a math error notice are no more likely to respond to a deficiency notice. That position overlooks the vast disparity between the appeal language in the two notices. Math error notices currently suggest only that a taxpayer call within 60 days if they disagree. The consequences of exceeding that time frame (loss of access to deficiency proceedings or tax court) are not mentioned. A deficiency notice, in comparison, addresses response procedures and appeal rights in detail.[19]

The National Taxpayer Advocate has commented elsewhere in this report about the Service's position that taxpayers' actual response (or lack thereof) to notices is a measure of the adequacy of a notice's effectiveness in meeting fundamental due process considerations.[20] *While a high taxpayer appeal rate may be an indicator that taxpayers understand the right to an administrative appeal, the response rate alone is not the only measure of taxpayer comprehension. A notice that clearly informs the taxpayer of his or her appeal rights is absolutely essential to a taxpayer having the opportunity to obtain those rights, whether or not he or she actually claims them.*

Any discussion of appeal rights should at a minimum specify:

- *the need to request an abatement should the taxpayer disagree;*
- *how to request the abatement; and*
- *what appeal options are preserved by a timely response.*

The difference in communication of appeal rights is only a small element of the TAS concern with the overapplication of summary assessments. The math error process affords more limited taxpayer interaction with the IRS and over a shorter period of time. Sixty days to interact with a customer service agent (who also may not realize the importance of declaring every disagreement as a request for abatement) is substantially different from the contact and time frames of deficiency proceedings.

These distinctions form the basis for a continued request for limitations on the application of math error authority. Determinations of fact and circumstance are inappropriate for the limitations of the math error process. The data contained in the Federal Case Registry (FCRSCO) is fundamentally different from that contained in the Social Security Administration's database. Errors with respect to a person's Social Security number, or interest paid on a mortgage loan, are numerical (quantitative) in nature and easily resolved. Where a child resides for more than half the year is inherently factual in nature, potentially changing from year to year.

[19] Robert B. Nadler, "Math Error Notices: In Search of Taxpayer Rights," Tax Notes Today, July 7, 2003, TNT 131-6, p. 5.

[20] See *infra* discussion of the Combination Letter.

As a matter of policy and fair tax administration, summary assessment authority should not be used in conjunction with this type of determination. In saying this, the National Taxpayer Advocate is not questioning the use of the FCRSCO as an audit selection indicator. She agrees that, when used in conjunction with other databases, the FCRSCO can help identify returns that warrant closer scrutiny. The National Taxpayer Advocate is challenging, however, the appropriateness and efficacy of the FCRSCO under math error procedures. TAS participation in setting up guidelines for using the FCRSCO in determining EITC dependency does not imply agreement with the legislated authority. TAS is participating in recognition of the difficulties this new authority will pose for taxpayers if implemented.[21]

Math error authority can be and was intended to be an efficient means of correcting errors identified in the course of return processing. Application of the process to more complex return preparation challenges, particularly those involving qualitative - not quantitative - judgments, are not justifiable at any cost savings, where the short cut inhibits the taxpayers ability to properly assert a legally acceptable position.

[21] The National Taxpayer Advocate notes that Congress recognized her concerns when it expanded math error authority in 2001, by requiring the Department of Treasury, in consultation with the National Taxpayer Advocate, to study the accuracy and appropriateness of the use of math error and summary assessment authority in connection with the FCRSCO. S. Rep. 107-30, p. 16-22.

MOST SERIOUS PROBLEM: NAVIGATING THE IRS

RESPONSIBLE OFFICIALS

Dale Hart, Commissioner, Small Business/Self-Employed Division
Henry O. Lamar, Commissioner, Wage and Investment Division
Frank Keith, Acting Chief, Communications and Liaison

DEFINITION OF THE PROBLEM

Taxpayers and practitioners cannot locate the function or employee at the IRS who has the responsibility and authority for resolving a particular tax problem. Even IRS employees have difficulty determining who is accountable for program areas within the reorganized IRS.

ANALYSIS: NEW DEVELOPMENTS

The National Taxpayer Advocate's 2002 Annual Report to Congress ranked "Navigating the IRS" as the Number One Most Serious Problem for taxpayers and practitioners, as well as for IRS employees.[1] In response, the IRS stated that it is building a network of tools and services that will simplify the process of navigating the modernized IRS for taxpayers, practitioners, and employees, but this approach requires a continuing long-term effort.[2] The IRS' initiatives included:

- New and improved intranet tools to help employees become more knowledgeable about the reorganized IRS, so they can be more helpful to taxpayers who need assistance;[3]
- Improvements in the toll-free telephone system, such as segmenting telephone services by customer type and need; and
- Enhancements to the public IRS website, http://www.irs.gov, to improve Internet communication between the IRS, taxpayers and practitioners.

Improved Intranet Tools

When taxpayers or practitioners contact the IRS for assistance, they expect that IRS employees can determine the appropriate official or area to handle their issue. However, since the post-1998 reorganization, employees found it difficult to assist taxpayers because a user-friendly, accurately updated directory of the reorganized IRS was not available. Employees were frustrated by an unclear management chain in the reorganized agency and by the difficulty of locating a person with the authority to take a particular action.[4]

[1] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 7.

[2] Id. at 9.

[3] The intranet is an internal web network for IRS employees.

[4] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 8.

The IRS has now provided IRS employees with an excellent organizational directory. The "IRS Roadmap," which made its debut in July 2003, is a website directory that locates primary management officials in all business units and in every geographic area. Employees can easily generate a concise table of telephone numbers for directors, area directors, and territory managers by location and business function. This directory also lists the names and telephone numbers of state disaster coordinators and state commissioner's representatives.[5] It provides a link to the IRS National Directory to view Headquarters executives, as well as a cross-link to the "Program Responsibility Matrix," to view program responsibility and ownership. Moreover, each operating division has a contact person responsible for keeping the Roadmap accurate and current.

The IRS has marketed the "IRS Roadmap" by placing a hyperlink to that web page on the IRS intranet home page, viewable by all IRS employees who use computers. The IRS communications office also e-mailed all employees a news release announcing the new tool.

By continuing to enhance its internal website for IRS employees, the IRS has taken a very important step to help taxpayers and practitioners find their way around the reorganized agency. The Servicewide Electronic Research Program (SERP), also featured on the intranet home page, provides employees with a multitude of contact information for various IRS program areas. However, employees are not given the time or training to become familiar with SERP and other resources available to them. The IRS may also make additions to the intranet, or redesign or relocate a site, without informing employees. The IRS must ensure that employees are trained in intranet use, as well as continually apprised of changes to the network. Once employees are adequately trained about the tools available on the intranet, they will be well equipped to guide taxpayers to the appropriate people to assist them.

New Communication Needed with Taxpayers

Before the IRS' most recent reorganization, it served taxpayers geographically. Today, the IRS serves segments of the taxpayer population that have similar filing characteristics, such as large corporations or small businesses; and IRS employees specialize in working tax returns and programs that have similar characteristics. One office may serve all taxpayers nationwide who are affected by a particular program, without the assistance of a field office in each state or major city. The geographical office a taxpayer has grown accustomed to working with may no longer be the appropriate place to contact with regard to his or her specific need. This organizational change required the IRS to develop new lines of communication with taxpayers. The IRS continues to enhance its automated services, allowing many customers to obtain answers without the need for human interaction. The

[5] The state's IRS Commissioner's Representative (formerly district director's representative) handles emergencies and makes decisions that affect the local field offices.

IRS regards automation as a strategic tool to increase the number of callers served by a limited number of representatives.[6]

The IRS is also collaborating with various external organizations to provide products and services to taxpayers. Through these partners, such as the Small Business Administration, taxpayers receive products and information that fit their particular situations. Taxpayers who qualify for the Earned Income Tax Credit (EITC) or the Child Tax Credit, or who need an Individual Taxpayer Identification Number (ITIN), may receive aid from public and private organiztions working with the IRS. Through partnerships with the IRS, organizations that taxpayers trust, including Low Income Taxpayer Clinics and other community organizations, are developing marketing campaigns to help taxpayers who may be starting their first job, opening a new business, starting a family, or planning retirement. Although these partnerships provide another avenue for taxpayer contact, the IRS must track the number of taxpayers that the partnerships assist and the type of aid they provide to determine their effectiveness.

Improved Toll-Free

The IRS has made numerous improvements to its toll-free telephone system. A nationwide, toll-free, accounts-related service for tax practitioners became operational in fiscal year 2002.[7] The IRS realigned and expanded its toll-free system in fiscal year 2003. New toll-free lines include a Business and Specialty Tax line for small businesses, corporations, partnerships and trusts that need information or help in preparing business returns; a Refund Hotline for series 1040 filers to check the status of their refunds; and an e-Help number for questions and issues concerning electronic filing products.[8] The IRS toll-free telephone system automatically transfers taxpayer calls to appropriate numbers dedicated to service their particular tax needs. Previously, for some specialized numbers, IRS assistors could provide the specific number, but the taxpayer had to make a separate call. The IRS has also updated its automated menu to provide callers with information about the 2003 Advanced Child Tax Credit.

An ongoing deficiency with "toll-free" is that the system does not provide taxpayers with the specific option of reaching a "live" assistor. Taxpayers only speak to assistors when they fail to make a choice within the toll-free menu. The National Taxpayer Advocate's 2002 Annual Report to Congress problem topic number 18, "Toll Free Level of Service (Access)" discusses problems with taxpayers' expectations to reach a live assistor, the time customers spend waiting on hold, and the routing of callers from one phone line to another.[9]

[6] Letter from J.R. Watson, Director, Customer Account Services (Wage and Investment Division) to John Boehm, Chairman Midwest Taxpayer Advocacy Panel (February 14, 2002.)

[7] The Practitioner Priority Service provides toll-free information about a taxpayer's specific account to practitioners who have power of attorney for that account. It is available at 1-866-860-4259.

[8] The Business and Specialty Tax number is 1-800-829-4933; the Refund Hotline number is 1-800-829-1954; the e-help number is 1-866-255-0654.

[9] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Revision 12-2002), p. 125-130.

Improved Internet Tools

For taxpayers and practitioners using the IRS Internet site at http://www.irs.gov, products and services are segmented by customer type: Individuals, Businesses, Charities & Non-Profits, Government Entities, Tax Professionals, and Retirement Plans. When customers choose a particular segment, further subdivisions direct them to the appropriate information. For example, the category of Charities & Non-Profits is divided into Business League Organizations (Orgs), Charitable Orgs, Employee Associations, Fraternal Societies, Labor & Agricultural Orgs, Political Orgs, Social Clubs, Social Welfare Orgs, and Veterans Orgs.

In addition to segmenting by customer type, the IRS website highlights frequently asked questions, such as inquiries about the status of a taxpayer's refund; requests for tax forms and publications; explaining where to file and how to contact local offices; and providing information about the 2003 tax cuts and the Advanced Child Tax Credit. The IRS promptly established a link on the Credit (ACTC). A series of ACTC explanations appeared on the website from May to August 2003, including a consumer alert issued June 18, 2003, warning taxpayers about a scam targeting potential ACTC recipients. The scheme involved a charge to the taxpayer's credit card to "speed up" the payment of the ACTC. Taxpayers can also check the status of their own ACTC refund on the site. Other useful links from the homepage include "Armed Forces Tax Benefits," installment plans for making tax payments, and advice for newlyweds and working students. The page also includes a link to the Taxpayer Advocate Service's homepage.

Although the Internet and the IRS public site are improving communication and services between taxpayers and the IRS, they are not a panacea for the problems taxpayers have in contacting the IRS. The IRS has done little to educate taxpayers about using its website. As reported in the IRS Customer Satisfaction Survey, W&I Market Segment Survey National Report, issued December 2002, "64 percent of Wage & Investment (W&I) taxpayers have Internet access at home and 74 percent of W&I customers are aware of the IRS website, yet only 17 percent used it." An outreach plan that provides taxpayers with widespread knowledge about its website would benefit the public and the IRS.

It is incumbent upon the IRS to provide quality customer service for all available contact methods, whether by telephone, by mail, over the Internet, or at a Taxpayer Assistance Center (walk-in site). "Individuals Online in 2007 and What This Means for Wage and Investment (W&I)", prepared for the IRS Director of Strategy and Finance, reported that low income, minority, and elderly taxpayers lack Internet access or experience, and therefore will continue to require conventional methods of customer service via telephone, mail, and walk-in assistance. However, some recent studies indicate that these three groups have been among the fastest-growing groups of Internet users:[10]

[10] Sources: U.S. Department of Commerce, National Telecommunications and Information Administration, "A NATION ONLINE: How Americans Are Expanding Their Use of the Internet," February 2002, available at http://www.esa.doc.gov/pdf/anationonline2.pdf, and Michael Pastore, "Demographics: Minority, Low-Income Internet Use Increases," available at http://cyberatlas.Internet.com.

Internet use is increasing for people regardless of income, education, age, race, ethnicity, or gender. Inequality among various groups is decreasing.[11]

"In 2000, the Internet has continued its growth toward becoming a mainstream medium... web usage is on its way to becoming pervasive... in light of the ability of the Internet to efficiently and effectively reach a wide variety of target consumer segments."[12]

These studies indicate that the IRS should continue to improve its website, and encourage the public to use it as alternative method of contact. However, increased Internet usage does not necessarily translate into computer - or Internet - literacy. In addition, the IRS site is not easy to navigate, especially for taxpayers new to computers and the World Wide Web. The IRS should develop and implement specific plans to help new Internet users, including low income, minority, and elderly taxpayers, gain experience and comfort in accessing the IRS site and using it fully to their benefit. If taxpayers are aware of and well educated about the assistance they can provide themselves online, IRS representatives will have more time to help taxpayers solve problems that automation cannot serve.

The IRS can do more

Even though the IRS has provided its employees with an easy-to-access, user-friendly directory, it has not done the same for taxpayers and practitioners. They must contact an IRS employee to do what many of them could do for themselves if the "Roadmap" directory was available on the public website at www.irs.gov. As reported in the National Taxpayer Advocate's 2002 Annual Report to Congress, the IRS replaced its planned Interactive Organizational Directory (IOD) with the IRS Directory for Practitioners (IDFP).[13] This directory is available for tax professionals on the public website but is not user friendly. Some of the problems with the IDFP include:

- Practitioners must search the directory by entering the name, title, or organization of the person responsible – the very information that practitioners are trying to obtain from the IDFP.
- The directory uses IRS jargon and abbreviations that can make searches unsuccessful and results hard to understand.
- When a search is successful, the results are difficult to read and may be missing important information, such as a telephone number or website address.

[11] U.S. Department of Commerce, National Telecommunications and Information Administration, "A NATION ONLINE: How Americans Are Expanding Their Use of the Internet," February 2002, available at http://www.esa.doc.gov/pdf/anationonline2.pdf.

[12] Michael Pastore, "Demographics: Minority, Low-Income Internet Use Increases," available at http://cyberatlas.Internet.com.

[13] National Taxpayer Advocate, *Annual Report to Congress,* Publication 2104 (Rev. 12-2002), p. 8.

- The "keywords" recommended by the directory often do not provide a match.
- The IRS designed the IDFP for practitioner use, but taxpayers can access it by choosing the "Tax Professionals" tab on the website. However, taxpayers are directed to the link for "Individuals," where there is no directory; nor is there a directory for business taxpayers. Once taxpayers do reach the directory, its design problems pose a major obstacle to effective use.

Improvements Needed for International Taxpayers

International taxpayers have an extremely difficult time contacting the IRS. Overseas taxpayers do not have access to toll-free lines yet are referred to toll-free numbers, for example to request an Employer Identification Number (EIN) or to request IRS forms or publications. Publication 1, Your Rights as a Taxpayer, and Publication 594, What You Should Know About The IRS Collection Process, refer taxpayers to toll-free numbers without providing guidance for those outside the United States. The gaps in these two widely used publications demonstrate the need to improve contact information for international taxpayers. The IRS needs to establish toll-free numbers – or a suitable alternative – for these taxpayers and publish links to the appropriate offices for assisting taxpayers abroad.

Lack of One-Stop Service

The Restructuring and Reform Act of 1998 (RRA 98) required that during a telephone or personal contact, the IRS employee give his or her name and unique identifying number to the taxpayer.[14] The Act further mandated that to the extent practicable and if advantageous to the taxpayer, one IRS employee should be assigned to handle a taxpayer's issue or problem until it is resolved; that is, serve as a single point of contact.[15] The IRS established the procedure of using an IRS employee's badge number as identification to comply with RRA 98. However, there is no directory of badge numbers to identify IRS employees. When the badge number cannot be associated with the name, phone number and location of the IRS employee who originally assisted the taxpayer, the taxpayer must explain his or her problem all over again to a different IRS assistor. Thus, reliance on the use of an employee badge number to identify an IRS employee speaking with a taxpayer is not meeting the Congressional mandate to provide taxpayers with a single point of contact with IRS.

Whether a taxpayer contacts the IRS online, by phone, by mail, or by walking into a Taxpayer Assistance Center, the IRS must do more to ensure that he or she receives one-stop service. IRS employees must be well trained about the research tools available to them to determine the appropriate function or person to resolve taxpayers' issues.

[14] Pub. L. No. 105-206, § 3705(a)(1)(3).

[15] Pub. L. No. 105-206, § 3705(b).

Furthermore, the IRS must develop an aggressive outreach plan to enlighten taxpayers about when it is appropriate to use the self-help services and benefits available using the automated phone system or the Internet, and when it is more appropriate for taxpayers to seek assistance from an IRS employee.

IRS COMMENTS

The long-term effort to build a network of tools and services that simplifies the process of navigating the modernized IRS for taxpayers, tax professionals and employees continued this year. The IRS made strides in measuring our customer service, fine-tuning our toll-free telephone system, streamlining our computer-based applications and expanding services to tax professionals and overseas taxpayers. Working from the recognition that one of the most important keys to navigating the IRS lies with employees, this year we delivered the "IRS Roadmap", as noted by the Advocate. The feedback on the "Roadmap" has been very positive with users describing it as an excellent product that is very user friendly. However, clarifications on some of the Advocate's other points are needed.

Employees

We disagree with the Advocate that employees are not given the time or training to become familiar with the resources available to them. The Customer Service Representatives (CSRs) are provided extensive training on the use of Servicewide Electronic Research Program (SERP): 12 hours for newly hired CSRs, annual Continuing Professional Education Refresher Training (CPE) and an hour per week to review updates to systems or technical information. Weekly group meetings are also often used to discuss quality issues that focus on the use of electronic research. When new tools are developed for the Internet, each CSR is given at least a 30-minute training module to alert them to the product and its use.

Customer Service Measures

The IRS already captures and reports on the number of taxpayers assisted through partnerships. Critical measures include the number of taxpayers reached through outreach and the number of returns filed through volunteer tax preparation programs. Effectiveness is also tracked through accuracy of return preparation and is being expanded to address issues such as service accessibility and interviewing effectiveness. EITC growth will be measured along with returns filed for FY 2004. With outreach, the IRS has also created (filing) and claimant databases to baseline existing issues and measures the impact of outreach initiatives.

Toll-Free Assistance

We disagree with the Advocate that there is a deficiency with the toll-free system. By design, taxpayers are not provided an option to go directly to an assistor during the menu selection process. The menu selection process serves a valuable purpose of identifying key information that allows IRS to route the caller to a Customer Service Representative (CSR) with the necessary skills. When a caller completes the process they will either connect to a CSR or be routed to an automated service point. For many common questions, our automated services are designed to address the most common questions we receive and offer the same information that would be available from our CSR with a quicker response time for the customer and a lower cost for the service. If an automation service does not fully satisfy the caller, they will be routed to an assistor. The Advocate is incorrect in stating that a caller can only speak with an assistor if they fail to choose from the menu.

Taxpayer Technology Education

We also do not agree that an aggressive outreach plan is needed for taxpayers. With current technology, self-help versus "live assistance" is far more efficient and germane to users' actual needs. The menu selection on our telephone system and our interactive Internet applications guide the user to the specific subject that he or she desires and, once the taxpayer has made a selection for service, he or she is directed to the most appropriate assistance. If the taxpayer does not know what menu item to select, he or she is sent to a "live assistor" who then directs the call to the appropriate service. We believe that these elements are as applicable for new, as well as for experienced users of the Internet and automated telephone services. When needed, direct education of potential users of the Internet to help them "gain experience and comfort" is best left to the many educational resources available in the larger community.

Tax Professionals

As the Advocate's comments point out, the Directory for Practitioners (IDFP), as developed and posted to the IRS website (www.irs.gov) in January 2003, was not meeting stakeholder needs. We decided to discontinue its use until we could design a more complete service for our stakeholders. However, during this timeframe other IRS tax products and services improved to give practitioners easier access to key IRS functional areas, such as the Automated Collection System (ACS) and the Practitioner Priority Service (PPS) toll-free phone numbers and, at the IRS website, the Tax Professionals page and many other landing pages. Tracking IRS accessibility through national practitioner organizations and our internal issue tracking systems shows that the IRS has achieved a level of accessibility satisfactory to our practitioners through these alternative approaches.

Overseas Taxpayers

The IRS is continuing to explore alternatives for providing cost free, or reduced cost, telephone service to our international customers. As an interim step we have established several toll numbers for use by international callers to assist with tax law questions as well as those questions relating to non-compliance issues, ACS issues and questions relating to EINs. Calls to these numbers are routed to units in Philadelphia that are specially trained to address international customer needs for both Individual and Business taxpayers.

Although the current international toll numbers are not yet included in all IRS Publications, they are provided in key publications such as Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad, that provides customers with information on local IRS telephone numbers (embassies) based in foreign locations. The publication also lists the toll telephone number as well as the Philadelphia mailing address for those taxpayers who wish to write. This same contact information for international callers is also available on the IRS website.

Collection notices sent to customers with international addresses currently include the toll number. In addition, starting in January 2004 many of the non-compliance notices sent to international addresses will be changed to also include the new international toll numbers.

One Stop Service for Taxpayers

IRS believes we are meeting the intent of RRA 98 in serving taxpayers. The key words in the mandate are “practical and advantageous to the taxpayer” which the IRS balances with technological and resource constraints.

Although the IRS strives to resolve all taxpayer inquiries and questions on the first contact, due to the complexity of the tax law, our supporting computer system environment and our extremely large and diverse customer base, we recognize that we are not always as successful as we and our customers would like. In both the toll-free telephone environment and the walk-in assistance centers, we provide our employees with the authority and tools to solve most inquiries when initially contacted by the taxpayer. But as a result of the complexities cited above, we have long recognized that we must specialize our employees’ skills to ensure that we balance service delivery with quality and efficiency.

A key element of making our system work is to properly identify the type of taxpayer inquiry early in the contact and match it to a self-service application or employee with the proper skills. The FY 2003 improvements to the toll-free telephone systems scripts, routing and segmenting telephone services by toll-free numbers have resulted in substantially more taxpayers reaching the right Customer Service Representative the first time. In the near future we will have additional tools that will provide on-line delivery of images of correspondence and certain forms such as amended returns, which will increase first-contact resolution and reduce taxpayer burden if a second contact is necessary.

To ensure that taxpayers know with whom they are speaking, employees are required to give both name and badge number. A directory of IRS employees by badge number is not published however in order to protect the privacy of the individual employee.

As a last resort, in order to balance customer needs and limited resources, service hours have been modified - at less than eight percent of our small Tax Assistance Centers. But in order to provide taxpayers with the right service at the right time in the right location, we offer appointments via local telephone lines. To ensure that the public is not inconvenienced, we have posted service hours on the IRS.gov website and as part of the local telephone script for the public and on the Servicewide Electronic Research Program (SERP) for the Customer Service Representatives. When closings do occur outside of the standard it is usually due to an emergency situation, which cannot be avoided and again only as a last resort when no alternative is available.

As noted by the Advocate, the IRS is currently studying procedural changes to TAC location analysis procedures. Until that analysis is completed, no TACs will be permanently closed. New TAC location analysis procedures will be finalized and implemented during FY 04.

TAXPAYER ADVOCATE SERVICE COMMENTS

We are pleased that the IRS has provided a national directory, The IRS Roadmap, for employees to locate primary management officials in all IRS business units by geographic area. We further applaud the continued enhancement of the Servicewide Electronic Research Program (SERP) for employees to determine contacts for various IRS programs, such as Appeals, Collection, Examination, and Offers-in-Compromise. SERP is also useful to determine who must file, where to file and send payments, and the location of Taxpayer Assistance Centers.

We recommend that similar tools be available for taxpayers to determine the person or work area to handle their issue. The IRS has not yet provided taxpayers and their representatives with a concise, easy to use IRS directory. These individuals must contact an IRS employee to determine how to proceed, when they could often find the information themselves, through plain-English searches, if a directory was available to them. The IRS Directory for Practitioners is still unavailable, pending redesign.[16]

The National Taxpayer Advocate recommends that The IRS Roadmap, or a similar directory, be added to the IRS public Internet site. The roadmap is easy to use, and because it is segmented by state, the output is very concise and would not overwhelm taxpayers and practitioners.

Additionally, the IRS needs to establish toll-free numbers or a suitable alternative for overseas taxpayers who do not have access to current toll-free lines, and to publish links to appropriate offices for taxpayer assistance abroad. We are pleased that while the IRS explores alternatives for providing low-cost or no-cost telephone service to international taxpayers, toll numbers have been established and included on collection notices to international addresses and in Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad. The IRS' plans to also include the toll numbers in non-compliance notices sent to international addresses beginning in January 2004, and to list these toll numbers in more publications, will help serve this taxpayer group. The National Taxpayer Advocate suggests that the IRS include these numbers in the next revision of Publication 1, Your Rights as a Taxpayer, and Publication 594, What You Should Know About The IRS Collection Process.

The National Taxpayer Advocate remains concerned by the lack of one-stop taxpayer service.[17] *Employees identify themselves to taxpayers by badge number, but there is no nationwide IRS directory of these numbers.*

The National Taxpayer Advocate recognizes the need to protect the privacy of IRS employees. However, even IRS employees cannot locate another employee by their badge number. The Internal Revenue Manual (IRM) specifies that employees must give their name and identification number from their identification card (badge) when assisting taxpayers in person or on the telephone.[18] *The IRM further states that a taxpayer may ask to speak to a specific employee who previously handled their inquiry by providing their name and ID card number and asking to discuss the account with that person. But the IRM instructs that the taxpayer not be put in contact with the original employee unless the current employee cannot resolve the situation, or "the taxpayer insists on speaking with the prior employee." These cases are forwarded to management, "who will attempt to locate the other*

[16] In October 2002, "The IRS Directory for Practitioners" to locate IRS officials was available on the IRS public website for a short time, but was removed from the site with plans make it available again after improving its search capabilities.

[17] Pub. L. No. 105-206, § 3705(a)(1)(3) and § 3705(b).

[18] IRM 21.1.1.7, Communication Skills.

(original) employee."[19] *It has been reported to the National Taxpayer Advocate that the original employee usually cannot be located. Therefore, although the IRS is furnishing taxpayers with a specific employee identifier per RRA 98 § 3705, it is not providing one stop service. Further, the National Taxpayer Advocate is concerned that the IRM instructions make it difficult for a taxpayer to speak with their original assistor. She agrees that the second employee can offer to assist the taxpayer without contacting the original employee, but only if the taxpayer agrees.*

The IRS has misunderstood what we are proposing with respect to employee badge numbers. We do not believe that taxpayers should have access to a database of employee badge numbers or aliases. However, IRS employees should be able to conduct a search by badge number, employee name, or alias, and transfer the taxpayer to that person. A more sophisticated system would permit an employee who is working on a case to identify "back-up" contacts who can handle calls when an employee is on vacation, on sick leave, or in training.

We applaud the IRS for its continued efforts to provide a network of tools and services for taxpayers, practitioners, and employees to access the IRS. However, the IRS must help the intended users become knowledgeable about these tools. Employees must be taught to probe and find the right person or business unit to which the taxpayer's inquiry should be directed, without concern about the length of time needed to complete the call, to minimize frustrated and "lost" or incorrectly referred taxpayers. And although Servicewide Electronic Research Program (SERP) training is provided to CSRs, they comprise only 12 percent of the IRS workforce.[20] *All employees must be given the time and training to know what tools are available to them, and kept informed about relocation of items on their internal website.*

The IRS is attempting to change the way taxpayers interface with their tax agency. In order to accomplish this realignment of expectations and established practices, the IRS must better inform the public of the various means of contacting the IRS for assistance. As the network of communication tools is expanded, the IRS must educate the public about them. We are not talking here about the menu selections available to the taxpayer once he or she enters our toll free system. Rather, an overarching communication strategy among IRS operating divisions is needed, followed by an ad campaign essentially "selling" taxpayers on how to reach the IRS, telling them what to expect, and explaining why one method of contact is better than another for different types of inquiries. The data the IRS has begun to track, regarding taxpayers assisted through partnerships, must be used to match product development with contact methods that work for taxpayers and with which they are comfortable.

[19] IRM 21.1.3.15, Request for Specific Employee.

[20] As of Sept 2002, of 121,025 total IRS employees, 14,528 were CSRs. Source: Workforce Snapshot.

The public IRS website is not easy to navigate. For example, the list of keywords contains only 27 keywords, some of which are IRS jargon and therefore unlikely choices for taxpayers.[21] *A keyword search often produces "no results" and directs the taxpayer to the general site search, which in turn presents a plethora of choices that can overwhelm taxpayers. The website needs to be more user-friendly. For example, we suggest that the table of toll-free numbers, which includes a brief description of each toll-free service, should be highlighted and easily accessible from the public website homepage.*

The National Taxpayer Advocate compliments the IRS for improvements to communication tools made in fiscal year (FY) 2003, which include addition of the IRS Roadmap directory, augmentation of online research tools for employees, and enhancements to toll-free telephone service. She looks forward to further improvements in FY 2004.

[21] As of December 11, 2003, there were 27 keywords listed on the IRS public website at http://www.irs.gov/help.

PROBLEM

TOPIC #10 MOST SERIOUS PROBLEM: NO RESPONSE AUDIT CASES

RESPONSIBLE OFFICIAL

Henry O. Lamar, Commissioner, Wage and Investment Division

DEFINITION OF THE PROBLEM

Despite Internal Revenue Service (IRS) programs to simplify correspondence and expand telephone assistance operations, taxpayers continue to disregard letters and proposed tax change reports sent to them by Correspondence Examination, the functional unit on IRS campuses (formerly known as Service Centers) that performs correspondence examinations of taxpayers. Taxpayers fail to respond to the reports for a variety of reasons, including:

- the use of form letters that are not specific to the taxpayer's particular situation;
- confusion about the meaning of the report because the taxpayer is not knowledgeable about tax law or tax processes, or English is not the taxpayer's primary language;
- the taxpayer agrees that he or she owes the tax but lacks the funds to pay the tax liability;
- fear of the IRS and tax enforcement actions;
- the perceived need for a paid preparer to handle tax-related issues; or
- the taxpayer moves without leaving a forwarding address (or the forwarding order has expired), thereby never receiving the IRS correspondence.

When taxpayers do not respond, the IRS ultimately assesses the proposed tax due and begins collection efforts. At that point, taxpayers often contact the IRS to request abatement of the tax through the audit reconsideration process. This pattern of events places an additional burden on IRS resources, which could be avoided if the taxpayer participated in the original audit, and the IRS assessed the correct amount of tax.

ANALYSIS OF PROBLEM

The General Accounting Office (GAO), in a 1999 study, noted that more than 50 percent of taxpayers who were audited by correspondence did not respond to the IRS' letters.[1] When asked why taxpayers failed to respond during the audit process, the IRS responded that it had not studied the issue but offered three likely explanations:

- Taxpayers may be overwhelmed or intimidated by IRS letters and may be uncomfortable with responding.
- Some taxpayers may not understand the letters and not know how to respond.

[1] General Accounting Office, *IRS Audits*: *Weaknesses in Selecting and Conducting Correspondence Audits,* GAO/GGD-99-48, March 1999.

- Other taxpayers may know that they owe the additional tax but hope their nonresponsiveness will discourage the IRS from trying to collect the tax.[2]

As a result of the GAO report, the IRS conducted its own study to find out why this large segment of the Correspondence Examination population failed to respond to letters and audit reports, and to identify ways to encourage taxpayers to respond.[3] To accomplish this goal, the IRS designed focus groups to gather first-hand information from taxpayers. Drawn from the Examination Closed Case Database, the desired participants were taxpayers who had received letters from the correspondence examination function but did not respond, and whose cases were subsequently closed by default.

The IRS decided to conduct focus groups in Chicago, Los Angeles, and Memphis, where approximately 27,000 taxpayers met the criteria for the groups. To locate these taxpayers and screen them for participation, their names and addresses were provided to an independent research group. Despite an exhaustive matching effort, the group was unable to find telephone numbers for 79 percent of the individuals on the list. Additional barriers included disconnected telephones and language problems. These and other issues limited the number of participants confirmed during the screening process.

Ultimately, only 22 taxpayers out of the initial group of 27,000 agreed to participate in the sessions. Fourteen of them subsequently failed to appear, leaving just eight taxpayers taking part in the interviews. Though this was disappointing, the IRS made the decision to continue the sessions with those who did appear. While the number of taxpayers interviewed may not have been a large representation of the original population, the information gathered from their interviews proved to be useful. The following responses are taken from the focus group interviews:

- Correspondence Examination letters and reports are complex and confusing. The concepts are difficult to understand. The letters are too general because they are not tailored to each taxpayer's specific tax situation.
- There were differing levels of satisfaction with Toll-Free Customer Assistance. Some participants appreciated the help they received from the Toll-Free assistors, while others reported difficulty and frustration with the assistance they received. One person was advised by a toll-free employee to call a toll number to attempt to resolve the problem. Others complained about the length of time they had to wait for assistance, and when they finally got through, the assistor was unable to help.
- Seven of the eight taxpayers used paid preparers to assist in filing returns, help them with tax matters, and respond to IRS correspondence. These taxpayers sought

[2] General Accounting Office, *IRS Audits*: *Weaknesses in Selecting and Conducting Correspondence Audits,* GAO/GGD-99-48, March 1999.

[3] Internal Revenue Service, Small Business/Self-Employed Division, Strategy, Research and Performance Management, Study of Service Center Correspondence Examination No Reply Assessments, Project Report 2.08, April 2001.

professional assistance because they did not clearly understand the intent of the letters and reports, or the documents were perceived to be of a legal nature. Some of the preparers said they would handle the correspondence but did not follow through to resolve the problems.

- An underlying theme in the focus groups was a sincere fear of the IRS. The participants said they knew that tax problems would not simply disappear. They believed that making a mistake on their tax return would result in consequences up to and including jail time. However, some noted that the IRS is just trying to do its job, and that if taxpayers make mistakes, they will have to pay penalties.
- The participants provided numerous possible reasons for ignoring IRS correspondence. The most common response was that they lacked the money to pay the tax, so there was no point in responding. Some believed that if they had made errors on their returns, the IRS would just correct them automatically. Some were frightened by what they saw as "legalese" in the letters. The participants agreed they should try to correct the problems because ignoring them only makes them worse.

The study authors made the following recommendations to improve the no-response rate in correspondence examinations:

- Simplify language in letters and tax change reports and personalize them to the taxpayer's specific situation;
- Expand toll-free service nationwide to include longer hours, add staff to manage the call volume, and use multilingual representatives;
- Provide education and outreach to the practitioner community regarding Correspondence Examination procedures; and
- Conduct additional focus groups using moderators fluent in other languages.

In 2002, the IRS conducted an additional study of the subsequent filing behavior of taxpayers who fail to respond to Correspondence Examination letters and reports.[4] This study was in response to the fact that up to 60 percent of taxpayers who claim the Earned Income Tax Credit (EITC) and receive an examination letter fail to respond.[5] A substantial number of these taxpayers subsequently request an audit reconsideration to determine if the IRS incorrectly disallowed the previously audited items, and whether the tax assessed as a result of the prior examination should be abated.[6] In addition, many of these same taxpayers fail to file subsequent year tax returns even when they are due refunds.[7]

[4] Internal Revenue Service, Research Group 4, Study of Subsequent Filing Behavior of Taxpayers Who Fail to Respond To Submission Processing Center Correspondence Examinations, Project 2.29, August 2002.

[5] Id. at 1.

[6] Internal Revenue Service, Research Group 4, Study of Subsequent Filing Behavior of Taxpayers Who Fail to Respond To Submission Processing Center Correspondence Examinations, Project 2.29, August 2002.

[7] Id.

To gain insight into the reasons for this behavior, the IRS analyzed the subsequent filing behavior of 722 EITC and 380 non-EITC taxpayers who filed returns for tax year 1998.[8] The analysis covered the filing history of these taxpayers for tax year (TY) 1998, 1999, and 2000, and found that:

- Fewer than five percent of the taxpayers in the estimated EITC population of 34,959 taxpayers and less than four percent of the estimated 7,183 non-EITC taxpayers requested an audit reconsideration. However, most of the audit reconsideration requests (84 percent for EITC taxpayers and 97 percent for non-EITC taxpayers) resulted in a full or partial abatement of the tax assessed because of the previous audit.
- With respect to filing compliance, 54 percent and 64 percent of the EITC and non-EITC taxpayers, respectively, filed returns for both subsequent tax years, TY 99 and TY00.
- With respect to payment compliance, 43 percent and 53 percent of the EITC and non-EITC taxpayers, respectively, paid the assessments in full for both subsequent tax years.
- The number of taxpayers failing to file a return increased with each successive year after TY98.
- When Information Return Program (IRP)[9] data was available, it showed that approximately 61 percent and 51 percent of the EITC and non-EITC taxpayers who did not file returns, respectively, would have been due refunds.[10]

[8] Internal Revenue Service, Research Group 4, Study of Subsequent Filing Behavior of Taxpayers Who Fail to Respond to Submission Processing Center Correspondence Examinations, Project 229, August 2002 at i-ii This sample was extracted from Examination's Audit Information Management System (AIMS) database, containing 42,142 taxpayers who received correspondence examination letters on their tax year 1998 (TY98) return and failed to respond. The objectives of this study were to:

1. Determine the number of EITC and non-EITC taxpayers who requested an audit reconsideration for TY98 during the collection process.
2. Determine the number of EITC and non-EITC taxpayers who failed to file and/or pay subsequent returns.
3. Determine whether EITC and non-EITC non-filing occurred only in the year after the audit or in multiple years.
4. Determine whether EITC and non-EITC non-filers were due refunds for the years they failed to file.

[9] IRP information is the data transmitted to IRS by payers for Forms W-2, 1098, 1099, K-1, and other information returns, which is matched against the actual tax returns filed by taxpayers to determine whether the information was properly reported on the tax return.

[10] The report also contains information on changes in the number of EITC claimants, filing status, and exemptions. For example, the findings indicate that the sample of taxpayers claiming EITC in subsequent years declined. Excluding non-filed returns, the percentage of taxpayers claiming EITC fell from 100 percent in TY98 to 48 percent in TY99 to just over 40 percent in TY00. The findings show an overall decrease in the percentage of two or more exemptions claimed by EITC taxpayers. Overall, for the baseline year, over 90 percent of the filers claimed three or less exemptions. In TY98, 89.6 percent of the EITC filers claimed two or three exemptions with 2.7 percent claiming one exemption. The percentage of EITC filers claiming two exemptions dropped from 63.9 percent in TY98 to 37.2 percent in TY99 to 33.6 percent in TY00. Over the same period, the number of filers claiming one exemption increased to 32.6 percent in TY99 and 37.0 percent in TY00. The number of exemptions claimed by Non-EITC filers remained constant over time.

The data also shows a sizable percentage increase in the number of EITC taxpayers from the baseline year who changed filing status from Head of Household to Single in subsequent years. A total of 87 percent of the EITC filers claimed Head of Household status in TY 98, dropping to 50 percent in TY 99 and 41 percent in TY00.

The IRS concluded from these findings that, since fewer than five percent of the taxpayers in the study requested an audit reconsideration, the correspondence examinations were correct. In addition, since the percentage of EITC filers decreased from 100 percent for TY98 (the baseline year in which everyone in the sample claimed EITC) to 48 percent claiming EITC for TY99 to just over 40 percent claiming EITC for TY 00, this indicated that the examinations had an impact on taxpayer behavior.[11]

The study's conclusions regarding the accuracy of no-response correspondence examination results do not take into consideration the many qualitative reasons taxpayers do not attempt to resolve a tax problem. For example, market research conducted for the Taxpayer Advocate Service (TAS) into the characteristics of TAS' currently underserved population demonstrates that some taxpayers are IRS-intimidated.[12] Other reasons for non-response include:

- lack of knowledge of tax law and IRS procedures;
- inability to communicate with IRS personnel due to language barriers or lack of education;
- the need for help from a tax professional, which they may not be able to afford; or
- non-receipt of notices and reports due to frequent moves.

Any or all of the above situations could contribute to the low rate of requests for audit reconsiderations.

In an effort to obtain more recent data for this report, the 2001 Compliance Research Information System (CRIS) was used to gather data on taxpayers that were audited for the years 1999 and 2000.[13] The following tables show the numbers of returns in the sample in which there was no response to the audits, the projected number of returns in the actual population, the numbers claiming EITC, and the number of business vs. non-business returns.

[11] See footnote 10 above for data on the changes in taxpayer behavior.

[12] Russell Marketing Research (RMR), Findings From Task 149 - The Taxpayer Advocate Service Research Program, July 2002. This telephone survey included 1,400 taxpayers who met the "currently underserved" criteria of being ages 18 to 64, had filed a federal income tax return in the past, and had experienced a TAS-qualifying problem in the past two years. A prior study conducted by RMR in 1999 for TAS' predecessor, the Problem Resolution Program (PRP), showed that 21 percent of taxpayers had experienced problems in filing their tax returns, but that 90 percent of them had not gone to the IRS for help.

[13] The CRIS database is a sample of tax returns filed that is used to project information to the total number of returns filed. The data gives no information about the reasons for the lack of response to audits because it is strictly numerical; however, it does indicate the magnitude of the problem. CRIS data for 2001 was also obtained, however, some of the sample sizes were too small for accurate projections; therefore, that data was not used.

TABLE 1.10.1, NUMBER OF RETURNS IN CRIS FOR TY99 AND TY00 WITH CLOSED AUDIT FOR TY99 OR TY00 AND DID NOT RESPOND[14]

TAX YEAR	Sample Size	Projected Population	No Response Sample Size	No Response Projected Population	No Response Percent of Projected Population
1999	739	427,357	176	105,174	24.6%
2000	570	422,567	214	168,706	39.9%

TABLE 1.10.2, NO REPLY CLOSED AUDITS FOR TAX YEARS 1999 AND 2000 BY EITC PRESENCE

	Proportion of No Reply Audits			Projection of No Reply Audits		
Tax Year	With EITC	Without EITC	Sample Size	With EITC	Without EITC[15]	Total
1999	80.9%	19.1%	176	85,067	20,107	105,174
2000	92.1%	7.9%	214	155,306	13,400	168,706

TABLE 1.10.3, NO REPLY CLOSED AUDITS FOR TAX YEARS 1999 AND 2000 BY SCHEDULE C OR F PRESENCE

	Proportion of No Reply Audits			Projection of No Reply Audits		
Tax Year	With Sch C or F	Without Sch C or F	Sample Size	With Sch C or F	Without Sch C or F	Total
1999	21.6%	78.4%	176	22,702	82,472	105,174
2000	16.3%	83.7%	214	27,446	141,260	168,706

These statistics indicate that large numbers of taxpayers are not responding to IRS letters and audit reports, for reasons that are entirely a matter of conjecture at this time. There is strong anecdotal evidence from IRS functional areas, including Examination, Taxpayer Service, and TAS caseworkers, as well as Low Income Taxpayer Clinics and others, that many of these taxpayers contact the IRS later, when collection efforts have begun. When they believe that the IRS has incorrectly assessed their tax, and/or they do not have funds to pay the tax, they often request audit reconsiderations in an effort to prove their tax liability should be lower or abated. This process can be very costly for the taxpayer and the IRS in both time and expense, and could be avoided if the taxpayer had participated in the audit process. The IRS Wage and Investment Operating Division (W & I) has requested that W & I Research Group 3 conduct a more comprehensive study of the reasons for non-response. This study is only in the beginning stages, and no data is yet available.

[14] Tax Years 1999 and 2000, Compliance Research Information System (CRIS), Model IFM 2003. Please note that the population data shown are projections only and may not be completely representative of the population as a whole.

[15] Due to the extremely small sample sizes, 37 for 1999 and 16 for 2000, projections may not be reliable for returns not claiming EITC. The figures are included to complete the totals for no reply audits while presenting the reliable figures for returns that claim EITC.

In 2001, the Treasury Inspector General for Tax Administration (TIGTA) performed an audit to determine whether the IRS effectively gathers and uses information from its audit reconsideration process to increase taxpayer compliance and improve customer service.[16] As part of the IRS' increased emphasis on taxpayer compliance and customer service, the W & I division formed a task force to review processes, procedures, and related information in the four program areas (Automated Substitute for Return (ASFR), Automated Underreporter (AUR), District Office Examination, and Campus Correspondence Examination) responsible for audit assessments.[17] The task force found deficiencies in the closure procedures for the original audit assessments and the absence of an information system to track audit reconsideration trends.[18]

The IRS lacks empirical data about the reasons why taxpayers fail to respond to correspondence examinations. Further, although there is clear evidence that IRS examinations influence taxpayer behavior, the IRS does not know whether this influence has a chilling effect on compliant, as well as noncompliant, taxpayers. Thus, it is premature to conclude that the IRS's correspondence examination procedures consistently lead to correct results.

IRS COMMENTS

The IRS is in agreement with the National Taxpayer Advocate that it is in the best interest of taxpayers and the IRS for everyone to respond promptly to IRS notices and requests for information. When taxpayers respond, it dramatically reduces case cycle time and usually results in a lower assessment for the taxpayer. To increase the response rate and better understand why taxpayers fail to respond, IRS is engaged in continuing research studies, test projects, and outreach efforts.

The National Taxpayer Advocate's report references a 2001 IRS research study concerning no responses cases and the study's recommendations.[19] This study recommended simplifying the language in letters and tax change reports to personalize them to the taxpayer's situation. In 2003, IRS introduced new letters and forms using reader-focused writing and simplified explanations. To make the correspondence specific to each taxpayer's situation, adjustment explanation paragraphs in the letters now only detail the specific items under review for that individual. Additionally, a new report was designed which contains only the line items adjusted during the audit. Internal and external stakeholders, including representatives of the Taxpayer Advocate Service, reviewed these changes.

[16] Treasury Inspector General for Tax Administration (TIGTA) *Management Advisory Report, Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service*, Reference # 2001-40-053, March 2001.

[17] Id. at ii.

[18] Treasury Inspector General for Tax Administration (TIGTA) *Management Advisory Report, Audit Reconsideration Cases Create Unnecessary Burden on Taxpayers and the Internal Revenue Service*, Reference # 2001-40-053, March 2001.

[19] Internal Revenue Service, Small Business/Self Employed Division, Strategy Research and Performance Management, Study of Service Center Correspondence Examination No Reply Assessments, Project Report 2.08, April 2001.

The 2001 research study recommended that IRS improve toll-free service and provide multilingual representatives. In 2003, the IRS conducted a test by mailing 6,000 notices to taxpayers that included a Spanish language offer to provide a Spanish language service or a Spanish version of the enclosed notice through a special toll-free number. Fourteen taxpayers called this number requesting that their audit package be re-mailed in Spanish and three also resolved their issues with the Spanish assistors. The impact of this test is still under evaluation. However, it does not appear that the offer of Spanish language service is one that will materially affect the response rate.

The 2001 research study also recommended that IRS provide education and outreach to the practitioner community. The IRS has actively participated at all six nationwide Tax Forums for the last several years where correspondence examination procedures are covered and special question and answer forums conducted with practitioners. In addition, during 2004 the IRS is planning extensive outreach on the correspondence examination process through their external partners serving low-income and non-English speaking populations. Public messages will reinforce the need to timely respond to IRS examination notices, the benefits of doing so, avenues for free or low-cost assistance, and the impact of not responding.

The National Taxpayer Advocate also refers to research studies showing fewer than five percent of the EITC taxpayers and four percent of the non-EITC taxpayers requested audit reconsideration.[20] However, of those who did, 84 percent of EITC and 97 percent of non-EITC taxpayers received full or partial abatement of the previously assessed tax. This data can be interpreted in several ways. One view is that these statistics reflect that once taxpayers request reconsideration, they are generally sustained. Another view is that the 95-96 percent that did not request an audit reconsideration chose not to do so because the IRS assessment was correct.

To better understand and improve response rates, the National Taxpayer Advocate and the IRS agreed to test the concept of sending an additional 30-day letter to the 25,000 taxpayers in the EITC certification proof-of-concept if they do not respond to the initial notice. This 30-day letter will be sent as a courtesy in an attempt to further solicit a response. The test will gauge the effects of this notice on overall response rates, taxpayer use of the Appeals process, and its impact on examination cycle time.

[20] Internal Revenue Service, Research Group 4, Study of Subsequent Filing Behavior of Taxpayers Who Fail to Respond to Submission Processing Center Correspondence Examinations, Project 2.29, August 2002.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes that the IRS is attempting to determine the reasons that some taxpayers do not respond during an audit. Based on the limited amount of research available on this issue, it is reasonable to assume that the reasons put forth in the Analysis section above, while possibly not all-inclusive, do encompass many of the actual reasons that taxpayers fail to respond. However, there are actions the IRS can take now to simplify the Correspondence Examination process, reducing both taxpayer and IRS burden and enhancing compliance, while further studying the problem.

RECOMMENDATIONS

In addition to initiatives described by IRS, National Taxpayer Advocate recommendations include:

- *Advertising through public service announcements the importance to the taxpayer of notifying the IRS of an address change using Form 8822, Change of Address, and inserting a direct link to the form on the home page of the IRS website at http://www.irs.gov/.*
- *Further simplifying IRS letters, notices, and reports to give clear instructions in an easy-to-understand format and that are specific to the taxpayer's situation.*
- *Providing the tax examiner's name and direct telephone number in all correspondence to allow the taxpayer to reach the examiner directly and ensure that he or she does not simply just "give up" when unable to reach the examiner using the current system or out of frustration with repeating the same information to different examiners.*
- *Providing examiners with toll-free direct telephone lines so that taxpayers are able to reach examiners without incurring additional expense.*
- *Giving reasonable timeframes for gathering the necessary documents to substantiate the issues under audit.*
- *Ensuring that all taxpayer correspondence is promptly associated with the taxpayer's case file.*
- *Providing a list of Low Income Taxpayer Clinics (LITC) at which qualifying taxpayers can receive professional help during the audit process.*
- *Capturing accurate information on the numbers, results, and costs of audit reconsiderations from all of the involved IRS functions so that the total cost to the IRS of no-response audits can be calculated.*

The National Taxpayer Advocate believes that implementation of the above suggestions would greatly reduce the number of audits that are closed without a response from the taxpayer and enhance compli-

ance in general. It is logical to assume that the costs of the additional service provided to taxpayers under audit would be partially offset by the savings from fewer audit reconsiderations. In addition, the IRS would be assessing the correct amount of tax, which should be the goal of every audit, while developing good relationships with audited taxpayers who often see the IRS as inaccessible and difficult.

PROBLEM

TOPIC #11 MOST SERIOUS PROBLEM: TAXPAYER ASSISTANCE CENTERS (TAC)

RESPONSIBLE OFFICIAL

Henry O. Lamar, Commissioner, Wage and Investment Division

DEFINITION OF THE PROBLEM

The Office of Field Assistance, within the IRS Wage and Investment Division, is reducing services available at Taxpayer Assistance Centers (TACs) with potentially significant, negative results for taxpayers. Some of the changes under consideration include:

- Closing offices,
- Limiting hours of operation, and
- Restricting access to services and assistance.

ANALYSIS OF PROBLEM

Field Assistance has been operating under the general guidelines of a "Concept of Operations" (CONOPS) created in August of 2001.[1] This document established a framework for providing service in the face of increasing demand and limited resources, under the slogan, "Providing the right services at the right time in the right location." To this end, the CONOPS declares a need to strictly define the scope of TAC service, and to provide a referral system for all other taxpayer inquiries.[2] The IRS made several changes for fiscal year 2003 to implement this strategy, designating certain smaller offices for closing; limiting the hours of operation for others that remain open; and restricting access to assistance. While TAS appreciates the need to refine the approach of Field Assistance to its customers in light of limited resources, the National Taxpayer Advocate is concerned about how these changes will affect taxpayers who, for any number of legitimate reasons, rely on TACs for services and assistance.

Office Closures

Field Assistance has been reviewing the status of smaller Taxpayer Assistance Centers (TACs), evaluating the ability of volunteer income tax assistance sites, mobile assistance units, or interactive "kiosks" to meet service needs more efficiently.[3] The review includes 80 TACs that are allotted only one staff year (Full-Time Equivalent, or FTE) and 39 other centers that have 2.5 FTE, and are situated within "commuting distance" of a larger TAC.[4] These are some of the issues considered by Field Assistance in deciding whether to close offices:

[1] Field Assistance, Concept of Operations, August 3, 2001.

[2] Id. p. 2.

[3] Field Assistance is looking to the IRS office of Stakeholder Partnership, Education, and Communication (SPEC) to leverage volunteer assistance through Volunteer Income Tax Assistance (VITA), Tax Counseling for the Elderly (TCE), the American Association of Retired Persons (AARP), Military volunteers, Low Income Tax Clinics (LITC) and other private partnerships.

[4] Full-Time Equivalent (FTE) funding indirectly equates to personnel available: 2.5 FTE may represent a variety of arrangements including two full-time staff and one part-time. Commuting distance is described as 45 minutes driving time or less. From an interview with the Director of Field Assistance. August 14, 2003.

- Are smaller offices less efficient to maintain in terms of facility and travel costs for employee training and management?
- Is demand sufficient to maintain service outside of the January to April filing season?
- Do smaller localities have a sufficient potential applicant pool from which to fill current and future TAC vacancies?

Although TAS understands and supports the desire to offer the best possible service with the resources available, TAS questioned the review process as well as certain assumptions about the ability of alternate services to replace face-to-face assistance. One study of walk-in service customers determined that certain customers would only benefit from the in-person service of a TAC because other alternatives had been tried without success, because the service was needed immediately, or because the service required was not available by telephone. [5]

Field Assistance is currently reevaluating the TAC location analysis procedures and will not close any offices at this time. The closure process was halted at the request of IRS Commissioner Mark Everson following inquiries by members of Congress, including Representative Paul Ryan (R-WI),[6] Senator Olympia Snowe (R-ME),[7] and Representative Nancy Johnson (R-CT).[8] While the Commissioner's action alleviates the immediate concern, the IRS must still consider the future of TACs, especially in rural areas. Reaching a TAC already requires a significant amount of time for some rural taxpayers. Is it reasonable to add up to 45 minutes of "commuting distance" to this trip?

Hours of Operation

According to the Concept of Operations, "Service hours will be primarily based on local traffic patterns and available resources."[9] Around the nation, this concept has translated to a standard schedule of 8:30 a.m. to 4:30 p.m., Monday through Friday.[10] In some offices, however, the posted schedule also includes a lunch closure from 11:30 AM until 12:30 p.m., just when taxpayers on their own lunch break might try to come in for assistance. The combined effect is a schedule that precludes access for taxpayers working daytime jobs, unless their employers will excuse an absence. Further, as Field Assistance moves away from using other IRS functions for back-up, offices may close for training or

[5] Walk-In Taxpayer Demographic & Attitudinal Profile Project 2.02, March 29, 2000, p. 15-17.

[6] Senate Appropriations Subcommittee on Transportation and Treasury, Question to Robert Wenzel, Acting Commissioner, IRS, April 9, 2003.

[7] News Release, "Snowe Fights Closing of Lewiston IRS Office," August 5, 2003, available at http://snowe.senate.gov/prt_taxes.htm.

[8] News Release, "Johnson Fights for Danbury Taxpayer Assistance Center," September 3, 2003, available at http://www.house.gov/nancyjohnson/press.htm.

[9] Field Assistance, Concept of Operations, August 3, 2001, p. 7.

[10] From http://www.irs.gov.

meetings.[11] Field Assistance procedures require posting temporary closures on the TAC toll-free message line and on the IRS internal and external web sites.[12] Notwithstanding these efforts, TAS continues to receive complaints from customers who were surprised to find locations closed. For example, on August 6, 2003, one couple drove more than 100 miles to make a payment at the Oklahoma City office. Finding the office closed they returned again the next day, making the payment only after accruing an additional day of interest on the debt and more than 400 miles between the two round trips. Even if the IRS is able to broadcast schedule changes to the public, some taxpayers will make the effort to reach a TAC during normal operating hours, only to find it closed.

Although current measures of TAC customer satisfaction do not indicate a problem with TAC accessibility, TAS notes an important flaw in this measurement: The IRS surveys the satisfaction of only those customers within TAC offices.[13] This may result in an overstatement of positive customer feelings about TAC locations and service hours, since the polls do not cover taxpayers who have not been able to reach a TAC office during standard or altered service hours. This would include taxpayers who have either waited in line only to be turned away at the door or have traveled long distances to find the TAC closed for an unscheduled training session. Nor is customer satisfaction data available for those who are directed to alternate services, such as kiosks.

Restricted Access to TAC Services

As noted previously, a key part of the Concept of Operations is clarification of the scope of TAC services. Field Assistance has defined the new scope in the "Field Assistance Operating Procedures, FY 2003 (FAOPS)."[14] Changes in the criteria for return preparation assistance have reduced the number of returns prepared by 10 percent from FY 2002 to FY 2003.[15] The National Taxpayer Advocate's FY 2002 Annual Report to Congress discussed return preparation assistance in detail. Key problem points included the decrease in the number of taxpayers served, the requirement of two in-person visits by the taxpayer to first schedule and then have the return prepared, and the need for both spouses to be present for the preparation of a joint return.[16]

[11] Field Assistance Operating Procedures, Fiscal Year 2004, Draft, June 10, 2003, p. 5.

[12] Memo from Director, Field Assistance, "Interim Guidance on Temporary Change in Service Delivery at Taxpayer Assistance Centers (TACs)," December 4, 2002.

[13] Internal Revenue Service, *Customer Satisfaction Survey National Report, Field Assistance,* covering mid-January through mid-April 20*03*, May 2003, p. 6.

[14] Field Assistance Operating Procedures, FY 2003, Amended March 10, 2003.

[15] From E-file Report, "Non-Profit Organizations", data source ELF 1541, October 20, 2002 and October 20, 2003. Electronic returns accepted, 2002 = 353,347; Electronic returns accepted, 2003 = 317,830. Percentage difference = 10.05 percent.

[16] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 95-103.

The new TAC scope eliminated date stamping of hand-delivered returns and effective October 1, 2003, limited TAC provision of tax return transcripts to taxpayers with documented emergencies.[17] These transcripts often "meet the requirements of lending institutions" and "demonstrate residency for Immigration and Naturalization Service (INS) purposes."[18] TACs will continue to provide tax account transcripts, but return transcripts, which show the actual entries on the original return, will now only be available via phone or Internet for non-emergencies. According to the IRS, the process of obtaining a return transcript takes about two weeks.[19]

TAS also received reports that TAC customers were turned away if staff could not serve them by the close of business or if a service quota had already been filled for the day. At the standard closing time on April 15, after waiting for more than an hour, some taxpayers were denied service, in spite of FAOPS provisions that each TAC would offer extended hours for filing deadline assistance.[20] In another example, customers complained after being told that a maximum of 25 Individual Taxpayer Identification Number (ITIN) applications would be accepted each day. The rule, not mentioned in the operating procedures, meant the next applicant had to wait for another day.

The National Taxpayer Advocate is concerned about this declining trend in providing services to customers of Taxpayer Assistance Centers and the resulting increase in taxpayer burden. She questions the analysis employed by Field Assistance in selecting services and locations for elimination. The IRS was not able to provide any data on the number of return transcripts provided by TACs in the past or any estimate of the cost-savings expected from cutting this service from the TAC menu. Similarly, when discussing potential TAC closings, Field Assistance mentioned a goal of ensuring that a TAC was within commuting distance for 85 percent of all taxpayers.[21] However, the operation could not explain how eliminating rural offices would help the IRS reach this goal. Further, Field Assistance has not sufficiently incorporated customer demographic analysis in service decisions. For example, a 2002 study of TAC customer characteristics, referenced previously, recommended continuing tax return preparation because one in three return preparation customers typically needed other TAC services anyway.[22] Eliminating the service would require those taxpayers to seek other return preparation assistance and still visit a TAC. Nevertheless, Field Assistance continues phasing out tax preparation.

[17] "Examples of documentation include an appointment letter from a government agency, financial institution or university with a very short deadline, proof of an INS appointment within two weeks of the request, or an airline ticket showing a departure from the United States within two weeks." Talkpoints for IRS Use With External Stakeholders, "Tax Return Information Copies (Transcripts)," W&I, Communications & Liaison, Rev. April 25, 2003, p. 2.

[18] Id. at 1.

[19] Id. at 2.

[20] Field Assistance Operating Procedures, Fiscal Year 2003, Amended March 10, 2003, p. 4.

[21] Information from the Director, Field Assistance, July 17, 2003. As of this date the IRS had 405 Taxpayer Assistance Centers, with 75 percent of taxpayers living within commuting distance of at least one TAC.

[22] Walk-In Taxpayer Demographic & Attitudinal Profile Project 2.02, March 29, 2000, p. 11.

In sum, the National Taxpayer Advocate is concerned that Field Assistance is pursuing more streamlined performance without making a full cost-benefit comparison to ensure that service changes result in a net improvement for all TAC customers.

IRS COMMENTS

The IRS continuously seeks to find the balance between high-quality service delivery and efficient use of resources. Our long-term vision, designed to support this goal, includes the following strategies:

- Broaden the use of electronic interactions;
- Offer products and services tailored to specific taxpayer needs;
- Implement a balanced compliance program to increase voluntary compliance,

The Taxpayer Advocate is correct that we have had to make adjustments to where and when we offer services but in each case the IRS has made every attempt to provide alternative methods and more focused use of our resources.

Closing TACs/Expanding Alternative Means of Service

IRS continues to develop alternate delivery methods to increase service to underserved areas; we are striving to achieve the balance between service needs and resource constraints. However, IRS is studying the process and data sets it is using in determining whether a TAC should be closed. Until the study is completed, no TACs will be permanently closed. The report should be completed during FY 04. The data-driven decisions used before this study began were based on the TAC workload analysis with the goal to provide service delivery locations that are within a 45-minute drive time for 85 percent of the taxpayers who file returns. We will increase service coverage primarily by placing multifunctional kiosks in non-IRS locations (including post offices, libraries, and shopping malls) and by using mobile units offering products and services tailored to specific customer needs. Since we seek to increase service coverage at the same time that we project no staffing growth, we must re-direct resources, close some TACs, and expand the use of alternate locations, mobile units, and kiosks.

Limiting Hours of Operation/Offering Appointments

As a last resort, we have had to modify services hours because of limited resources at less than eight percent of our small TACs. But in order to provide taxpayers with the right service at the right time in the right location, we are now offering appointments via local telephone lines. To ensure that the public is not inconvenienced, we have posted service hours on the IRS.gov web site and as part of the message the public hears when calling the local number. Customer Service Representatives also have this local reference if a taxpayer calls our toll free national number. When a closing does occur outside of the standard, it is usually due to an emergency situation and usually occurs in those posts where, due to resource constraints, we only have one employee. This is another reason that we are stressing alternative means of service and making appointments.

Restricting Access to Services and Assistance/Focusing Services and Assistance

The IRS is committed to providing the right services at the right time and in the right locations to all taxpayers who need assistance. Each year, we evaluate the services we provide in the TACs to identify ways to use our limited resources more efficiently. If face-to-face assistance is not required and there are other reasonable options for taxpayers to obtain assistance, we encourage taxpayers to use these options (i.e., toll-free telephone assistance and the Internet) to obtain the services they need. This was one of the main reasons we decided to phase out providing tax return transcripts in our TACs. Both the Internet and phone applications for this service will provide easy accessibility and quick turnaround time for the taxpayer. The TACs will continue to provide needed service on an emergency basis. The elimination of date stamping of hand-delivered returns was done because it is an unnecessary step in the process. Timeliness determinations are not tied to the date stamping process.

The IRS does not have service quotas for any of the services provided in the TACs. The items mentioned in the Advocate's report (i.e., customers turned away if a service quota had already been filled for the day and taxpayers denied service on April 15th after waiting for more than an hour) were isolated instances and all TACs have been and will continue to be reminded of the appropriate procedures.

The IRS believes that tailoring our services to meet specific taxpayer needs makes the best use of our limited resources. Our goal is to provide taxpayers with those face-to-face services that cannot be obtained as quickly or more efficiently with better quality elsewhere in the IRS or at more convenient times and locations with partnering volunteer services in the community. This is particularly true with return preparation for low-income taxpayers. Our efforts to expand and increase our voluntary assistance cadre have resulted in more free return preparation services than could ever be delivered in our TAC sites within IRS resource allocations.

TAXPAYER ADVOCATE SERVICE COMMENTS

TAS acknowledges the challenges facing the IRS in nationwide delivery of local assistance to a diverse population. While not minimizing those challenges, we are compelled to emphasize again the need for improved data-driven service choices and carefully evaluated results.

The IRS justifies discontinuing certain TAC transcript services because transcripts are available in other service formats. We continue to ask what benefit this change will bring to overall TAC service delivery, and whether TAC policy is flexible enough to recognize and assist taxpayers truly in need of assistance.

Since this change was implemented, TAS assisted a taxpayer who could be described as "frantic." He needed a transcript to secure a mortgage for the pending purchase of a home and would forfeit his $1,000 application fee if he failed to provide the information within a day or two. A call to IRS customer service yielded a suggestion to take his emergency request to the large TAC nearby. There, the taxpayer was told he could not receive assistance without proof of the emergency. The taxpayer went to his lender and obtained a letter confirming his urgent need, but upon his return to the TAC, the employee looked at the letter, pulled his account information and then told him it could not be printed. In desperation, the taxpayer called TAS. A case advocate gave the taxpayer what he needed and closed the case the same day.[23]

As the IRS points out, isolated service errors will occur. Yet this instance of disservice would not have happened if return transcripts were not restricted by policy – a policy selected because other offices could do the job, not because data demonstrated an opportunity to free limited service resources. For example, taxpayers need documents date-stamped for reasons other than timeliness determinations; where a document has been lost by the IRS, the date-stamped copy is proof that the IRS physically received the document. Policy decisions regarding services such as date-stamping should be preceded by surveys about taxpayer need for and usage of these services.

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations with respect to Taxpayer Assistance Center activities:

- *Any reduction in TAC service must be supported by a compelling business case. A successful process would enable IRS stakeholders to judge whether the change contributed to an overall improvement in service delivery.*
- *As the IRS does modify local services, TAS recommends developing customer satisfaction measurement techniques that accurately poll the customers affected. The traditional measurement, conducted within TAC walls, is not sufficient to reflect the impact of intended improvements.*

23 Taxpayer Advocate Management System (TAMIS).

RESPONSIBLE OFFICIAL

Henry O. Lamar, Commissioner, Wage and Investment Division

DEFINITION OF THE PROBLEM

Enacted in 1975 and expanded numerous times, the Earned Income Tax Credit (EITC) includes complex rules and eligibility requirements.[1] The IRS faces many challenges in administering the EITC, while low income taxpayers face enormous difficulty understanding and complying with requirements for claiming the credit. This administrative complexity causes two problems: millions of people who are eligible for the EITC never claim it, while the IRS receives a multi-billion dollar volume of excessive or erroneous EITC claims from other taxpayers.

The IRS needs additional outreach and educational programs about EITC for taxpayers and practitioners alike, to improve taxpayer awareness, reduce taxpayer confusion, reduce practitioner tax return errors, and improve compliance with the EITC.

ANALYSIS OF PROBLEM

The Earned Income Tax Credit is a tax program that plays an essential role in reducing poverty by creating significant work incentives for many low income Americans, and providing a cash supplement that lifts many out of poverty.[2] Despite the successes of the EITC, aided by strong Congressional oversight and IRS initiatives to assist the working poor in obtaining benefits, many eligible taxpayers fail to claim the credit or maximize its benefits.

Results of Current EITC Research

Internal Revenue Service research conducted in 2002 estimates that up to 3.4 million eligible taxpayers did not participate in the benefit program in tax year 1996.[3] The General Accounting Office (GAO) estimates that 4.3 million or 25 percent of eligible households in 1999 did not claim the EITC.[4] Among taxpayers who do claim the EITC, a significant portion of the EITC error rate in *overclaims* is not deliberate but is due to mistakes that are attributable to confusion about the complex rules and provisions of the program.[5]

[1] The Tax Reduction Act of 1975, Pub. L. No. 94-12 (H.R. 2166); Title II § 204, Reductions in Individual Income Taxes, March 29, 1975. Substantial expansions were adopted in 1986, 1990, and 1993. It has grown from a program involving $1billion in claimed credits for 6.2 million recipients in 1975 to one of over $36 billion and over 20 million recipients in 2003. EIC Report #701-98-11, IRS Wage & Investment Division Monthly Operating Review of EITC, July 2003.

[2] The EITC lifted 4.7 million people (including 2.6 million children of low income workers) out of poverty in 1999. U.S. Census Bureau, *Current Population Survey.*

[3] "Eligible Non-Claimants Profile," Wage & Investment Division Research Project # CR 26. This study covered findings for TY 1996.

[4] General Accounting Office, *Earned Income Tax Participation,* GAO-02-290R, December 14, 2001, p. 2.

[5] Department of Treasury & Internal Revenue Service, *Compliance Estimates for Earned Income Credit Claimed on 1999 Returns*, February 28, 2002, p. 15.

Adding to the immense challenge the IRS faces in reaching and engaging the target population is the high turnover rate of EITC claimants. A recent analysis by the Wage and Investment Division and a Department of Treasury/IRS task force on EITC reforms found that approximately 30 percent of tax year 2000 EITC claimants did not claim the EITC in the previous year.[6] For the IRS to effectively reach this constantly shifting group, many of whom have limited English proficiency, it must conduct ongoing research to develop and maintain an in-depth understanding of the population and respond to its needs. An effective communication plan also requires a resource commitment dedicated to delivering aggressive outreach and achieving measurable results in increased participation among eligible taxpayers.

The IRS received approximately $875 million in special congressional appropriations for EITC compliance initiatives between 1998 and 2003.[7] Congress directed the IRS to use the funds to expand customer service and public outreach programs, and enhance EITC-related research efforts as well as strengthening enforcement and compliance activities.[8] The IRS has not, however, devoted an adequate level of activity and resources to EITC outreach.

In its most recent compliance study, the IRS reported that of the $31.3 billion in EITC claims made by taxpayers for the tax year 1999, an estimated $8.5 to $9.9 billion (27 to 32 percent) should not have been paid.[9] Knowledgeable observers and other organizations experienced in dealing with this population have pointed to flaws in the analysis and have questioned the conclusions represented.[10] For example, in the subject study, the IRS used essentially the same procedures in notifying taxpayers of the need to substantiate eligibility as it does in the EITC examination process. The significant "no response"/undeliverable mail rate of 39.4 percent in EITC examinations in FY 2003, and the dearth of research available to date concerning the nature of EITC noncompliance and why taxpayers make errors, may lead to questionable conclusions about population eligibility for the EITC.

The GAO has listed the IRS' administration of the EITC among the high-risk areas for the federal government.[11] The IRS conducts ongoing efforts to address compliance prob-

[6] W&I District Office Research and Analysis, "EITC Churn Rate": TY 1999 & 2000, analysis conducted in 2002.

[7] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, H.R. Rep. 2014, August 5, 1997.

[8] Department of Treasury & Internal Revenue Service, *Earned Income Tax Credit Program Effectiveness and Program Management* FY 1998-2002, February 28, 2002, p. 2.

[9] Department of Treasury and Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns*, February 28, 2002, p. 15.

[10] These groups include the American Bar Association, The Brookings Institute and the National Taxpayer Advocate. *See also* Leslie Book, *The IRS's EITC Compliance Regime: Taxpayers Caught in the Net*, 81 Or. L. Rev. 351 (2002).

[11] General Accounting Office, *Continued Progress Necessary for Improving Serviced to Taxpayers and Ensuring Compliance*, Testimony Before Congressional Committees, May 20, 2003, p. 18.

lems in the EITC program. In FY 2002, the IRS received approximately $146 million to administer the EITC and reported that through EITC examinations and tax return adjustments,[12] it protected approximately $1.1 billion in revenue.[13]

Funding EITC Outreach and Education

However, the IRS has been less than vigorous and less than visible in demonstrating that the benefits delivered in EITC outreach and education have significantly impacted the participation rate of EITC-eligible taxpayers. Nor has it shown that its return tax preparer strategy has stemmed the tide of abuses attributable to untrained or unscrupulous preparers, or of equal importance, prevented dishonest preparers from practicing in low income taxpayer communities. On balance, the IRS has not focused the same level of attention on increasing participation in the EITC, or on educating low income taxpayers about how to file correct claims, as it has on addressing the compliance aspect of erroneous claims.[14]

One reason for this imbalance in program focus and delivery may stem from IRS resource distribution and funding allocation. In FY 2003, the IRS expects to direct less than 12 percent of its total EITC funding to outreach and education programs, while reserving almost 80 per cent of its funding to treating potential overclaims.[15] Thus, of the approximately $145 million Congress has allocated for the EITC program in FY 2003, IRS plans call for only $17 million to be directed toward improving awareness of and reducing confusion about the EITC. Even then, some of the designated outreach and education funding is directed toward curbing erroneous claims.[16] The disproportionate level of EITC funding associated with compliance-related activities may limit the IRS' ability to increase the participation rate in the EITC. Thus, while the EITC has one of the highest participation rates among federal anti-poverty investment programs, its effectiveness is largely attributable to the ease with which the tax system disburses benefits and is not necessarily the result of intense outreach or education campaigns.

Dollar expenditures cannot be solely relied upon as a determinant of program emphasis, and on a dollar-for-dollar per capita basis it may be more costly to address unsubstantiated claims than to conduct a targeted outreach program. In fact, the IRS uses outreach funds to leverage the support of partners through the Stakeholder, Partnership, Education

[12] Account adjustments include mathematical errors.

[13] FY 2002 EITC Appropriation Report, Publication 3763. The document consists of a tracking of IRS Earned Income Tax Credit initiatives. It is provided to members of Congress and to IRS executives.

[14] H.R. 2756, introduced July 16, 2003, directs the Commissioner of Internal Revenue to establish an earned income public awareness campaign of $15 million dollars annually (2004-2014) to increase public awareness and educate Americans of the earned income credit.

[15] EITC FY 2003 Distribution, Source: EITC Project Office.

[16] A portion of the $4.7 million dollar allocation for outreach and education in Taxpayer Communication and Education is directed toward initiatives that support targeted prevention of erroneous EITC claims. Source: EITC Project Office

and Communication (SPEC) organization.[17] However, in light of the enormous gap in understanding and the significant level of inadvertent error in the EITC, outreach and education may actually be more cost-effective than compliance-related activities in reducing EITC overclaims.

In the past several years, the IRS has made considerable progress in leveraging assets for EITC-related education and public outreach programs. The IRS has refined its approaches toward reaching non-claimants and others who need help understanding requirements for and claiming the EITC. For example, the IRS recently expanded efforts to revise EITC taxpayer assistance products and materials for promoting the EITC, updated publications and EITC forms and instructions, and began to address the needs of Limited English Proficiency (LEP) taxpayers through a Multi-Lingual Initiative.

Through August 2003, the IRS experienced total growth of nearly 10 percent in the number of EITC recipients and a 14 percent increase in EITC dollars claimed compared to the previous year.[18] Though this growth represented an historic high for EITC claims, the increases can primarily be attributed to the state of the economy and the 2002 EITC tax law changes rather than activities associated with outreach and education. For example, the IRS estimated that an additional 400,000 military personnel would become eligible for the EITC as a result of a tax law change.[19]

Advanced EITC Payments

The IRS has increased its effort to showcase the availability of and benefits to taxpayers of advanced EITC (AEITC) payments.[20] However, AEITC participation continues to decline. The number of EITC claimants requesting advanced payments fell from 156,000 (.08 percent of all EITC claimants) in 2001 to 128,000 (.06 percent) in the first half of 2003.[21] Additional research into the reasons for this continued decline, such as studying how recipients use the EITC and how the funds would be used if additional payments were received monthly may help the IRS to target outreach and education to those taxpayers who can benefit from such a payment regime.[22]

[17] Through media, mailings, E-services and seminars, the SPEC outreach program leveraged over 135 million-taxpayer contacts on income tax law, the EITC and electronic filing during FY 2003 (through 6/15/03). Source: EITC Project Office.

[18] IRS Wage & Investment Division, Monthly Operating Review of EITC, EIC Report #701-98-11, through August 2003.

[19] Beginning in TY 2002, earned income no longer includes nontaxable employee compensation, such as housing allowances. During the TY 2002 filing season, Volunteer Income Tax Assistance (VITA) maintained 242 military tax prep sites. The IRS did conduct some partnering efforts with the Armed Forces Tax Council to help military personnel, their dependents and other employees on military establishments worldwide (Source: IRS EITC Program Office).

[20] IRS Shareholder Partnership, Education and Communication, Business Plan for FY 2003, Business Objective # 5B.

[21] IRS Wage & Investment Division, EIC Report, January-July, through cycle 200317.

[22] For example, ShoreBank of Chicago conducted a study into the uses of EITC refunds and what taxpayers usually saved for.

Understanding the Target Population

The IRS has conducted beneficial research to determine why potentially eligible taxpayers do not claim the EITC and to prevent the unintentional claiming of the EITC. The IRS has completed a survey of taxpayers who did not respond to IRS notices that they may be eligible for the EITC.[23] Comments from survey participants indicate they lack knowledge and understanding of the EITC. The conclusions of the study support the need for increased marketing toward taxpayers potentially eligible for the EITC.[24] The IRS is currently considering implementing the recommendations made in this study that included:

- Increasing marketing to taxpayers who are potentially eligible for the EITC.
- Focusing marketing efforts specifically toward potentially eligible taxpayers without qualifying children.
- Developing a "word-of-mouth" marketing campaign.
- Using postcard marketing as an outreach tool to educate taxpayers on the EITC.

Further research into the characteristics of taxpayers who are eligible for the EITC, but do not claim it, will aid the IRS' efforts in understanding and reaching the target population. Psychographics research about the population's attitudes toward receiving government assistance can be helpful.[25] Knowledge of taxpayer behavior will enhance the IRS' ability to meet the needs of eligible taxpayers, encourage their participation, and achieve a more inclusive program, while reducing the likelihood of incorrect EITC claims.

Strategies for Improvement

An effective EITC outreach strategy also includes work with the tax return preparer community, which is responsible for filing nearly 70 percent of the tax returns claiming the EITC. Returns filed by paid preparers contain the same types and percentages of errors as those that are self-prepared.[26] Return preparers are responsible for 68 percent of errors or overclaims on EITC returns.[27] A strong, integrated IRS program strategy to educate tax practitioners about EITC-related errors and addresses compliance issues can improve tax preparer conduct, help ensure more accurate EITC-filed returns, and increase participation by eligible taxpayers. A key legislative recommendation, elsewhere in this year's Annual Report to Congress, addresses return preparer education in the EITC, suggests stronger use of penalties where abuses exist and advocates additional steps to mitigate problems caused by preparers.

[23] IRS Wage & Investment Division EITC Project 1-02-12-3-003, Survey of Taxpayers Who Receive IRS Notices, Research Group 1, November 2002.

[24] Id.

[25] Psychographics refers to qualitative data about target population attitudes, views and learning patterns that augment basic demographic information about these groups.

[26] IRS Wage & Investment Division Strategy & Program Plan FY 2003-2004, p. 76.

[27] Treasury Inspector General for Tax Administration, *Opportunities Exist to Improve the Administration of the Earned Income Tax Credit*, Reference # 2003-40-139, June 2003, p. 5.

While the IRS has begun some promising initiatives, it can do more to improve taxpayer awareness, reduce confusion and address taxpayer apprehension about complex EITC rules. Ensuring that eligible taxpayers are aware of and claim the EITC is in keeping with an IRS strategy aimed at preventing erroneous claims. Thus, IRS performance measures and outcomes should incorporate goals that address increased EITC participation when establishing objectives to prevent incorrect claims from being paid.

In educating and reaching out to the EITC population, the IRS must work with a constantly changing population base that includes a significant percentage of newly eligible taxpayers each year.[28] The IRS can utilize its research in taxpayer demographics, attitudes, literacy and language proficiency to train front-line employees who conduct outreach or provide assistance about how to proactively identify issues of concern to the potential EITC claimant. Further, the IRS must improve telephone assistance capability and be prepared to train employees and managers in Taxpayer Assistance Centers in technical and communication skills.[29] In addition, continued expansion of the Multi-Lingual Initiative, in particular by providing written EITC-related products to help taxpayers understand tax laws, will substantially benefit eligible claimants who have limited English proficiency.

External partnerships promoted through W&I SPEC are an important aspect of outreach and education and should continue in earnest.[30] These organizations play a role in curbing erroneous claims through a growing network of community-based volunteer organizations and groups conducting education and outreach activities. External stakeholders provide a non-threatening system of delivering EITC awareness, eligibility education, tax return preparation and financial literacy, all of which are essential to helping taxpayers understand and comply with tax requirements.

IRS COMMENTS

In June 2003, the IRS announced a five-point initiative for improving the administration of the EITC. One of these initiatives is to encourage eligible taxpayers to claim the EITC by increasing outreach efforts and making the requirements for claiming the credit easier to understand.

28 W&I District Office Research and Analysis, "EITC Churn Rate": TY 1999 & 2000, analysis conducted in 2002.

29 For example, a recent audit of IRS personnel at Taxpayer Assistance Centers found that employees who were asked questions about claiming the EITC answered incorrectly 27 percent of the time. Treasury Inspector General for Tax Administration, *Trends in Customer Service in the Taxpayer Assistance Centers Continue to Show Procedural Causes for Inaccurate Answers to Tax Law Questions*, Reference # 2003-40-158, August 2003, p. 25.

30 Roger Colton, writing on behalf of the National Fuel Funds Network, a nationwide alliance of charitable energy assistance providers, noted on July 10, 2003, in response to IRS Notice 2003-40 that for this population, phone contact is ineffective and that free Internet is not sufficient. SPEC is studying how taxpayer groups receive their information - by radio, television, trusted intermediaries, restaurant placemat, or other sources.

We agree with the Advocate that funding allocated for outreach should not be directly compared to that allocated for compliance activities. With each dollar spent on outreach activities, we touch many taxpayers. Conversely, compliance activities address specific reporting issues for a single preparer or claimant. Due to the nature of the activities, compliance requires significantly more resources. It is important to note, however, that in FY 2004 we have significantly increased our EITC outreach budget.

In summary, we are encouraged by our EITC outreach accomplishments and new initiatives as described below. These initiatives address the Advocate's concerns and position us to achieve our goal of encouraging eligible taxpayers to apply while reducing erroneous claims.

IRS INITIATIVES TO RESOLVE PROBLEM

Outreach Campaign

The IRS uses a business model that integrates tax education, volunteer tax preparation, financial literacy, and asset-building initiatives through national and community-based partner coalitions. By identifying and working with partners that share educational objectives with the IRS and importantly, have access to and credibility with affected taxpayers, we have created extensive outreach capabilities.

National Media Campaigns

Increasing participation in the EITC is a major component of the advertising and media campaign each year. The 2003 public service campaign was a vigorous bilingual campaign composed of advertising, direct marketing, and public education initiatives. Our audio and print public service announcements (PSAs) were circulated throughout the country and carried an ad value of over $2 million.

The 2004 EITC media campaign is focused on changing taxpayers' expectations - to show that the IRS is working to ensure all eligible taxpayers get what they honestly deserve, the EITC. Even though the eligibility requirements are complex, we are striving to simplify our messages to spark taxpayers' interest and direct them to a source of help. This might be the IRS toll free number, www.irs.gov, a community group, or a tax preparer. All campaign material will be targeted to the EITC eligible population, including a special outreach to Limited English Proficiency (LEP) taxpayers and single taxpayers. In addition to print, radio, video news releases, and outdoor advertising, there will be direct mail and electronic resource tools for tax preparers, bi-lingual products to support IRS employees, and an electronic press kit.

A new component of this year's campaign is our Hispanic grassroots initiative to be conducted in Los Angeles and Miami to reach the heart of the Hispanic community through word-of-mouth marketing. The grassroots initiative is the result of an extensive study conducted in 2003 of LEP taxpayers. This initiative will involve town forum events and specialized street teams to distribute EITC information in neighborhoods.

Outreach and Education To Tax Preparers

We agree that an effective EITC outreach strategy must include the tax return preparer community. The key messages for tax preparers for the 2003 filing season focused on both education of eligibility requirements and compliance with the rules. We mailed over 20,000 jumbo postcards to tax preparers who had filed 75 or more EITC tax returns in 2001. IRS also presented a one-hour special presentation on EITC for the web based practitioner information program entitled "Tax Talk Today," which is viewed by thousands of tax professionals.

The EITC Tool Kit for Tax Professionals contains information on eligibility requirements, the most common EITC reporting errors, and resources for assistance. In addition, five new products were developed for tax preparers to display in their offices to inform and educate clients on the eligibility requirements. The new materials were distributed to tax preparers at the 2003 Tax Forums and are available online.

Our participation in the National IRS Tax Forums provided EITC information to over 16,000 tax preparers. Two EITC seminars were held at each forum with one additional session targeted for preparers who service clients with limited English proficiency. The EITC Hot Topics seminar was a presentation of a panel that focused on the Commissioner's new five-point initiative aimed at improving the administration of EITC. Focus groups were held at four of the forums. The focus groups allowed the preparers to discuss issues they have identified that discourage participation in the EITC. The views of the preparers are being used to improve outreach strategies and materials.

The preparer outreach campaign for filing season 2004 also includes several new resource kits, available electronically and in print. In December 2003, IRS sent a direct mail package to over 15,000 tax preparers that will include EITC educational material for themselves and their clients.

Improve EITC Tax Returns Filed By Tax Preparers

Historically, returns filed by paid tax preparers contain the same types and percentages of errors as those that are self- prepared. The objective of the Return Preparer Strategy is to identify preparers with a significant number of EITC errors and provide them with special assistance and oversight, with a goal of reducing future EITC errors.

Recognizing that we needed a more aggressive approach to identify and educate high-risk preparers, we re-engineered our Return Preparer Strategy for 2003 to tailor our approach based on the preparer's history. Those with a history of egregious non-compliance with eligibility requirements will be the subject of Due Diligence visits and subsequent fines if they fail to comply with the due diligence requirements. We will be personally contacting practitioners who have prepared over 100 EITC returns with a high volume of errors to provide targeted educational materials. The results of these approaches will be tracked to assess their effectiveness and future return preparer outreach strategies.

Research on the Diverse EITC Taxpayer Population

We agree that research is the foundation for effective EITC outreach and are conducting several studies to better identify and understand the diverse EITC population. We have developed a multi-year research plan to better understand taxpayer segment values, behaviors, and preferences. In 2003, we developed data that identifies local EITC issues, down to a zip code level, which allows us to tailor education programs for the needs of specific communities. We now have community baselines from which to measure progress in increasing EITC participation and decreasing EITC errors through outreach. In addition, we have begun to link IRS systemic data such as telephone call site issues, volumes and trends, Taxpayer Assistance Center issues, and the National Taxpayer Advocate's walk-in issue database to improve our efforts. A cross-functional initiative is planned to analyze why EITC claimants do not respond to EITC correspondence. Ongoing research projects include:

- EITC Pre-Refund Audit Non-Response Survey - to identify why taxpayers receiving EITC pre-refund audit notices do not respond to correspondence audits.
- Rejected E-File EITC Returns - to identify preparers who filed paper EITC returns after an e-filed return was rejected.
- Impact of Coalitions Outreach - using historical data to establish a baseline in determining if coalitions and partnerships are having an impact on participation.

The Advocate suggests that additional research is needed into the reasons advanced EITC (AEITC) continues to decline. Our regular EITC outreach efforts generally include an awareness of AEITC as well. Information packets that are distributed by the IRS, partners and coalitions contain information on the AEITC (Pub. 1749 and 1844). Current research shows the following reasons are associated with why taxpayers do not claim the AEITC:

- The temporary or short-term duration of a job (e.g. a seasonal job).
- There is a fear of having to reimburse the IRS for possible overpaid advanced EITC claims resulting from unpredicted changes in family or working conditions.
- Employers are reluctant to deal with the required "paperwork" or the additional "real cost" of reporting to the IRS of the AEITC claims.

Evaluation to Ensure Future Success

As the Advocate mentioned, a necessary component in developing effective outreach and compliance activities is a reliable measure of the effectiveness of the activities. During FY 2003, we made significant progress in establishing EITC performance measures. We have established GPRA measures for FY04 to measure the participation in the EITC program. Our goal is an 80 percent participation rate for FY04, which represents a five percent increase over the GAO reported participation rate. We have established performance and diagnostic measures for all functions responsible for outreach activities.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate appreciates and applauds IRS plans in 2004 to focus increased attention and resources on outreach and education for EITC eligible taxpayers and other taxpayers who, over time, may become eligible. The five-part program for improving EITC administration was announced this past June by the Commissioner. It includes an enhanced focus on outreach and education to reach more of the EITC eligible segment. This will also benefit the IRS by achieving improved levels of compliance and reducing the error rate on EITC filed tax returns. It is clear from the IRS response, above, that the IRS is taking seriously its commitment to taxpayer education and outreach.

The ongoing efforts cannot be realized without addressing, in earnest, the problems caused for EITC taxpayers by some practitioners in the tax return preparer community. We are encouraged that the IRS recognizes the importance of educating preparers and disciplining unqualified, incompetent, or unscrupulous ones. We are especially pleased that the IRS will be taking a more aggressive stance in this regard in the coming year. We encourage the IRS to review its position on the National Taxpayer Advocate's 2002 legislative proposal for regulation of return preparers, and consider her additional preparer proposals in this year's report.[31]

We are also encouraged that the IRS has confirmed it will devote significant time and resources into research of the target population, and that the IRS expects tangible results in the form of increased participation by the intended beneficiaries of the EITC.

We find it curious, however, that the IRS has not made inroads into addressing any of the limitations uncovered about the failure of the advanced EITC to take hold despite IRS' inclusion of the AEITC in the FY 2003 business plan. Finding a common ground with large employers in publicizing advantages of the AEITC for their employees could, for example, be one area of focus.

31 National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Revision 12-2002) p. 216-230. *See also* part 2 in this year's report.

We commend the IRS for its work in the area of financial literacy and asset-building. Establishing a link between the EITC and saving is an important step for the EITC population toward financial security. The IRS Office of Stakeholder Partnerships Education and Communication should continue to work with the banking community to promote use of the AEITC as well as the year-end payment of EITC to encourage low cost or no cost savings accounts.

A major component of success in EITC administration will be the IRS' work with community-based organizations and other like-minded stakeholders who together engage the low income community. We agree that soliciting and nurturing these partnerships and utilizing feedback from them to help shape policy will serve to strengthen the dialogue around the EITC and create a less resistant, more open environment from which to succeed.

Overall, we applaud the IRS for identifying key areas in which to focus its outreach and education efforts and then developing innovative strategies to address those areas. The National Taxpayer Advocate believes that a well-integrated program of taxpayer and tax preparer outreach, community and business partnerships, and utilization of research results, will enable the IRS to conduct a meaningful and effective outreach and education campaign. Incidentally, it will reduce the incidence and cost of EITC noncompliance.

PROBLEM

TOPIC #13 MOST SERIOUS PROBLEM: EARNED INCOME TAX CREDIT NONFILERS

RESPONSIBLE OFFICIAL

Henry O. Lamar, Commissioner, Wage and Investment Division

DEFINITION OF PROBLEM

The Earned Income Tax Credit (EITC) has been praised for the high participation rate among its intended beneficiaries, yet millions of eligible taxpayers, particularly those whose incomes fall below the threshold requirements for filing a tax return, fail to claim the credit simply because they do not file returns. Moreover, many eligible taxpayers are unaware that they qualify for the credit or how to claim it.

The IRS is responsible for ensuring that low income taxpayers are not deterred by the filing process and for encouraging and assisting taxpayers, including those who would otherwise not have a filing requirement, to file returns in order to apply for refundable tax credits. Efforts to promote tax filing among the eligible working poor as a means of obtaining tax benefits, such as the EITC, should be a tax administration objective equal in significance to that of reducing EITC non-compliance.

ANALYSIS OF PROBLEM

The EITC adds significantly to the incomes of working poor households.[1] The EITC's benefits include:

- Reducing poverty;
- Promoting work; and
- Helping low-income families build assets.

A significant number of eligible families fail to claim the credit, although a greater percentage of individuals participate in the EITC than in traditional social welfare programs such as Temporary Assistance For Needy Families (TANF), food stamps, and Medicaid. As a consequence of not filing tax returns, however, qualified needy recipients lose an important source of income, totaling billions of dollars.

Table 1.13.1 below presents the EITC participation rate as estimated in five studies conducted over the past decade. These studies quantify the non-claimant problem by estimating the percentage of families and workers eligible for the EITC and the percentage of underclaims.

[1] Taxpayers claimed over $36 billion in Earned Income Tax Credits for tax year 2002, allocated among nearly 21 million recipients, through August 2003. Source: IRS EITC Report # 701-98-11.

TABLE 1.13.1 ESTIMATED PARTICIPATION RATES AMONG TAXPAYERS ELIGIBLE FOR THE EITC

Author (year)	Tax Year Analyzed	Population	Participation Rate Among Eligible Filers
Scholz (1994)	1990	All filers	80%–86%
Liebman (1996)	1990	Filers in "phase-in" range	70%
		Filers in "plateau" range	83%
		Filers in "phase-out" range	88%
Hill et al. (1999)	1993–94	One-parent families receiving AFDC in CA	42%–54%
GAO (2001)	1999	Families with children	86%
		Workers without children	45%
IRS (2002)	1996	All filers	82%–87%

Source: The Brookings Institution EITC Series, January 2003.

Particular subsets of eligible low income households are less likely to claim the credit than others. Groups that are least likely to participate include:

- Taxpayers with very low income;
- Taxpayers with a history of public assistance receipt;
- Larger families; and
- Workers without children.[2]

Additional survey research suggests that low income Hispanic parents and families whose first language is not English are also less likely than other groups to know about and file for EITC.[3]

The IRS can do more to encourage and assist those eligible for the EITC to request the credit by filing tax returns. A 2002 IRS study of the tax year 1996 participation rate in the EITC calculated that at least 17 percent (+/-0.9 percent margin of error) of potential EITC claimants are nonfilers.[4] The study further found that:

- Between 2.3 million and 3.4 million individuals eligible for the EITC failed to file a tax return, a prerequisite to obtaining the credit.[5]
- Between $2.1 billion and $3.5 billion in EITC was not claimed in the study year.[6]

[2] Alan Berube, "Rewarding Work Through the Tax Code: The Power and Potential of the Earned Income Tax Credit in 27 Cities and Rural Areas," Brookings Institution, January 2003.

[3] Katherine Ross Phillips, "Who Knows About the Earned Income Tax Credit?" Urban Institute, 2001.

[4] *IRS Participation in the Earned Income Tax Credit Program for Tax Year 1996*, Research Project 12.26, January 31, 2002, p. 16. The study utilized data from the U.S. Census Bureau.

[5] Id.

[6] Id.

- Approximately 40 percent of the EITC nonfilers were taxpayers without qualifying children.[7]
- Approximately 94 percent ($3.3 billion of $3.5 billion) of unclaimed EITC dollars would have gone to the remaining 60 percent of potential recipients; that is, those households with qualifying children.[8]
- EITC nonfilers generally had lower incomes than eligible individuals who filed a tax return to get the EITC.[9]
- Thirty-five percent of eligible individuals not claiming the EITC had income levels insufficient to require the filing of a tax return.[10]

The largest number of EITC nonfilers live in four of the five most populous states: California, Texas, New York, and Florida. These four states together accounted for 40 percent of the EITC nonfilers and 44 percent of the EITC dollars not claimed.[11]

Additional research findings include:

- Twenty-four percent of the EITC nonfiler population immigrated from Hispanic countries.[12]
- Only 7.5 percent of EITC nonfilers lived in public housing.
- More than one million EITC nonfilers participated in food stamp assistance programs (30 percent of all EITC nonfilers).
- More than one million EITC nonfilers participated in the free school meals assistance programs (30 percent of all EITC nonfilers and about half of all EITC nonfilers with qualifying children).[13]

The IRS study represents first steps in describing and identifying EITC non-claimants and begins to define the broad characteristics of the target population. Encouraging those who qualify to apply for the credit and assisting them to do so is of critical importance to achieve the goal of full participation by EITC-eligible taxpayers. The IRS needs to define and address the nonfiler problem and develop strategies to ensure more qualified nonfilers are aware of and claim the credit. For example, the IRS should evaluate existing nonfiler data to identify demographic characteristics and then formulate market-specific

[7] *Participation in the Earned Income Tax Credit Program for Tax Year 1996*, Research Project 12.26, January 31, 2002, P. 20.

[8] Id.

[9] Id. at 21.

[10] Id. at 22.

[11] Id. at 24.

[12] Id. at 31.

[13] Id. at 32.

approaches, targeting those taxpayers who may be eligible for the EITC but do not file a tax return.[14]

The IRS has experienced some success in recent years in assisting eligible taxpayers to claim the credit by issuing taxpayer notices. The IRS sends letters to individuals who file tax returns and appear to be eligible for the EITC but do not request the credit on their returns. In tax year 2000, the notices encouraged more than one quarter of EITC eligible taxpayers with children and nearly one half of EITC eligible taxpayers with no qualifying children to file and claim the EITC.[15] The majority of taxpayers surveyed who had responded to the notices indicated they either did not think they qualified for the EITC or did not know about the credit.[16] Understanding how to reach identifiable EITC non-claimants in these circumstances will provide valuable information about reaching the entire eligible population, including those who do not file returns.

The IRS can positively impact this problem through further qualitative research that assesses nonfiler attitudes, opinions and knowledge of the EITC, evaluates levels of EITC public awareness and measures the effectiveness of various publications and communication materials. The IRS communication strategy should explore who is best suited to deliver what messages to the EITC population. That is, with certain messages, the IRS might turn to its community-based partners for support in delivering them.

The IRS should consider employing unique approaches to reach the significant portion of the population that speaks English as a second language, moves from location to location, and/or lacks basic knowledge of the tax system. By developing communication products that target preferred venues for receiving messages, and supporting an increased partnering effort, the IRS can benefit recipients and encourage a higher response rate among this hard to reach, EITC-eligible taxpayer population.

IRS COMMENTS

The Advocate's report correctly highlights one of IRS' significant challenges - to effectively promote the Earned Income Tax Credit (EITC) so that all eligible taxpayers claim the credit. While the IRS has aggressively promoted the EITC for several years, we recognize that new, innovative approaches are needed to close the gap between eligible taxpayers who apply and those who do not. The IRS recently demonstrated its commitment to address this issue when we included increased outreach as one of our five key EITC initiatives.

[14] *IRS Participation in the Earned Income Tax Credit Program for Tax Year 1996*, Research Project 12.26, January 31, 2002 p. 47. Interestingly, a relationship may exist between individuals who fail to claim the EITC yet appear eligible and those who become non-filers in the following year. Data suggests that nearly one in five (17 percent) individuals issued notices by the IRS indicating they appear to be eligible for the credit in one tax year do not file a tax return in the following tax year.

[15] IRS Research Group 1, Survey of Taxpayers Who Receive IRS Notices, Project 12.62 (1-02-12-003), October 2002, p. 3.

[16] Id. p.12

One of the key implications of the Advocate's report is that the IRS needs to learn much more about the EITC-eligible population - a position with which we wholeheartedly agree. While the current EITC participation rate is already higher than rates in many other types of means-tested anti-poverty programs - a fact we attribute, in part, to our current outreach efforts – we recognize there is more we can do. In the coming year, we plan to design and conduct a number of tests to explore new ways to conduct outreach that go beyond the methods we currently employ. Our goal is to better understand EITC taxpayer behavior so that we can use our resources most effectively to reach them.

To ensure that this issue receives the attention it deserves, the IRS established a critical performance measure for EITC participation. Our FY 2004 goal is that 80 percent of eligible EITC taxpayers will claim the credit – an increase of five percent over the level reported in the General Accounting Office (GAO) study. To measure where we stand in accomplishing this goal, the IRS has chartered a new research study that will be developed in conjunction with the Advocate's office and other outside experts. It is important to note that the GAO study highlighted in the Advocate's report shows a significant rate of nonparticipation (45 percent) by taxpayers without qualifying children. While we believe that all eligible taxpayers should claim the credit, the maximum amount of the credit for these taxpayers is significantly less - $382 vs. a maximum of $4,204 for taxpayers with qualifying children. By contrast, this study shows the nonparticipation rate for EITC claimants with children is approximately 55 percent.

As we noted above, the IRS has had significant success in reaching potential EITC participants. For example, we have a process to identify taxpayers who, based on their tax return, appear to qualify for the EITC. As a result, during FY 2003, the IRS sent almost one million taxpayers a letter explaining the EITC criteria and how, if they qualified, they could apply. As mentioned in our response to the issue of increasing EITC outreach, we are:

- Providing comprehensive EITC services of education, outreach, and assistance to low income taxpayers through our national partnerships and local community-based coalitions.
- Contracting the services of a nationally known marketing/advertising firm to develop the 2004 filing season EITC marketing and media campaign. The strategies for the new campaign are research based and will be national in scope with targeted advertising in English and Spanish. Targeted advertising will be in areas - including those cities identified in the Advocate's report - where there are a high number of non-participating individuals who may be eligible for the EITC.

- Implementing a multi-year research plan to better understand taxpayer segment values, behaviors, and preferences to refine outreach contents and techniques. These studies should provide us with new insights into nonparticipation by limited English proficient taxpayers.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes the challenge that the IRS faces in closing the participation gap affecting those taxpayers who may be eligible for the EITC but do not file tax returns. Many of these taxpayers view the IRS and all government agencies with suspicion, and need coaxing to break long-held fears about dealing with the government. The Taxpayer Advocate Service can make a valuable contribution in helping to reach these individuals. We look forward to working with the IRS to conduct further research and fashion an ongoing strategy to address this issue and bring more eligible taxpayers the benefits they deserve from their work.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS work with Low Income Taxpayer Clinics (LITCs) in its outreach efforts. The clinics' major activities include representing low income taxpayers in IRS disputes and working with English-as-a-second-language (ESL) taxpayers to deliver outreach and education about taxpayer rights and responsibilities. Many clinics are part of or partner with community service providers. The trust built with the target population by these organizations, which are often concentrated in communities where high nonparticipation exists, can serve as another source of information about this group and help build support for them.

The Taxpayer Advocacy Panel, which has issue committees addressing the EITC and the needs of multilingual taxpayers, can provide the IRS with a source of citizen comment on how best to address the non-participant population. Both the TAP and the LITCs should be included in the panoply of groups from which the IRS seeks feedback.

The IRS continues to enlist the support of religious and charitable groups, community colleges, labor organizations, the banking community, utility companies and large employers in designing a strategy that reaches within the community to spread the word about the benefits of filing. Social service agencies and others in the professional community who often interact with this population can also be of assistance in this regard.

In addition to an improved marketing strategy to reach more low income taxpayers, the key to increasing the participation rate of EITC eligible nonfilers and meeting IRS goals is to follow through with a comprehensive research plan. Having missed an opportunity to begin this process earlier, dur-

ing the time of a major expansion in the EITC program 10 years ago, the IRS must begin to study the psychographic as well as demographic characteristics of the EITC population: with this information in hand, it can frame an outreach and education program that can reach most, if not all, EITC-eligible taxpayers.

PROBLEM TOPIC #14

MOST SERIOUS PROBLEM: MASTER FILE TRANSACTION 31 SEPARATING JOINT TAX ACCOUNTS OF SPOUSES

RESPONSIBLE OFFICIALS

Henry O. Lamar, Commissioner, Wage and Investment Division
Dale Hart, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

Taxpayers experience problems when the IRS must separate joint tax modules, or records, where only one spouse requests relief from a tax liability. This request for relief may occur in proceedings such as bankruptcy, offer-in-compromise, petitions to the United States Tax Court, joint and several liability, examination issues, and Taxpayer Assistance Orders.

Problems can occur when:

- The IRS suspension of the Collection Statute Expiration Date (CSED) and the Assessment Statute Expiration Date (ASED) affects both spouses on the joint tax module.
- As a result of the suspension, the IRS may inadvertently not pursue collection or examination activities against the spouse not requesting relief.
- Moreover, the CSED or the ASED for the spouse not seeking relief may expire while the IRS processes the request for the other spouse.

ANALYSIS OF PROBLEM

Master Files

The IRS maintains taxpayer account data on Master Files, which are collections of all taxpayer data from magnetic tape records, tax returns, and related documents filed throughout the nation.[1] For taxpayers who file the Form 1040 series of returns, the IRS maintains most of those records on the Individual Master File (IMF).

The IRS identifies and controls individual taxpayer account data on the IMF by the Social Security number (SSN) or the Individual Taxpayer Identification Number (ITIN). When a married couple elects to file together, the first SSN or ITIN on the Form 1040 identifies the taxpayer account data. While the IRS uses that first or "primary" SSN or ITIN to identify the taxpayer account data, it can access or locate the data with the SSN or ITIN of the second spouse. However, the IRS uses the primary number to identify, control, and change the data.

A tax module is a record of tax data for a specific tax return of a specific taxpayer that covers one tax period. The three items that identify an individual tax module are the

[1] IRM 21.2.1.3.2 Master File (Rev. 10-01-2003).

SSN or ITIN; the Master File Transaction (MFT) Code, which identifies the return; and the tax period. For the Form 1040 series of returns, the IRS uses MFT Code 30.

Each set of taxpayer account data has an entity section called an Entity Module. In addition to the primary taxpayer's name and address, the entity module includes information about filing status used on a return, the name and SSN or ITIN of the second spouse listed on the return (the secondary spouse), and other data.

The IRS uses the Integrated Data Retrieval System (IDRS) to access, research, control, and adjust taxpayer account data. On joint returns, the first or "primary" SSN or ITIN is used to access the data.

Processing Tax Relief Requests

In most situations, when a taxpayer files a return and later requests relief from some or all of the tax, the IRS is required to suspend collection and/or examination proceedings until the request is investigated and resolved, with the suspension recorded on each module on IDRS. This action may be triggered by one of the following:

- Bankruptcy - when a taxpayer petitions the U.S. Bankruptcy Court;
- Offer in Compromise (OIC) - when a taxpayer requests an OIC;
- Tax Court - when a taxpayer petitions the result of an audit or Appeals determination to the United States Tax Court;
- Joint and Several Liability - when a spouse requests full or partial relief from joint and several liability under IRC § 6015; or
- Form 911, Application for Taxpayer Assistance Order (ATAO) - when a taxpayer turns to TAS to request relief from significant hardship due to the administration of IRS policies or procedures.

While collection and examination activities on these tax modules are suspended in almost all situations, the limit on the time the IRS has to collect and examine is also suspended. Thus, the IRS does not lose any of the time it is allowed by statute to pursue collection and examination activity. The time limitation, or expiration date, by which the IRS must take collection or examination action, is recorded for each IMF tax module as the Collection Statute Expiration Date (CSED) or the Assessment Statute Expiration Date (ASED). The IRS uses IDRS to change or adjust these dates when necessary.

When taxpayers submit relief requests, the IRS will generally adjust the taxpayer account data three times. The first adjustment records the receipt of the relief request and suspension of collection and examination activity. Next, at completion, the relief determination is recorded on the tax modules. Finally, the IRS adjusts affected modules to show the new CSEDs and ASEDs.

Problems occur when only one spouse on a joint return, or the "requesting spouse," submits a request for relief. For a joint return, the taxpayer account data for one tax module on the Individual Master File (IMF) represents both spouses. This means that suspensions of collection and examination activity for one spouse apply to both, and that changes to the CSED and ASED for one spouse will also apply to both.

The IRS is allowed to pursue collection and examination activity against the spouse who did not file the relief request, the "non-requesting spouse." However, in some cases the suspension of activity for the requesting taxpayer unintentionally suspends this activity for the non-requesting spouse as well. The IRS may not try to collect a balance due while the relief request is processed, which can take years. Thus, the non-requesting spouse is also impacted because penalties and interest continue to accrue. Further, the collection period for the non-requesting spouse may expire before the IRS processes the request for relief.

Non-Master File (NMF)

Currently, the IRS splits joint tax modules after the relief request has been processed. Initially, the IRS would split the module identified with Master File Tax (MFT) Code 30 by moving the information from the Individual Master File (IMF) for one spouse to tax modules established on the Non-Master File (NMF). These NMF modules are identified with the same three items as IMF modules; that is, the SSN or ITIN, the MFT code, and the tax period. The Non-Master File tax code is 20 for these NMF accounts.[2]

There are many limitations associated with the taxpayer account data in the NMF. Adjustments such as payments or refunds must be made manually and require considerable time to process. Penalties and interest must also be manually computed. There is no automated cross-reference between the NMF and regular Master Files, including IMF. The taxpayer account data on a NMF tax module account reflects an assessment of tax from a return or other source document and may not represent the entire liability for a tax period. An additional tax assessment for the same tax year is established on the NMF as a separate account.[3]

Initial Rollout of MFT 31 to Master File

Beginning in January 2001, the IRS moved the processing of certain relief requests from the Non-Master File (NMF) to Master File (MF) using MFT 31. The movement of MFT

[2] Internal Revenue Manual 21.7.12.4.1.1, NMF Husband Only/Wife Only Assessment - Claims Filed; IRM 3.17.46.1.12(53), Glossary of Computer Terms; and IRM 3.27.68.1.22, Non-Master File - MFT Codes IDRS.

[3] Internal Revenue Manual 3.17.46.1.1(1)(b), General, Automated Non-Master File Accounting.

31 to Master File allows the IRS more flexibility to make additional assessments or other adjustments, and to cross-reference other tax modules on the Master File. However, the process of establishing a split account on Master File is still time consuming. The remaining MFT 31 problems include:

- The MFT 31 module is still established after the IRS processes one spouse's request for relief.
- MFT 31 cannot be established on Master File when the name and identification number for one spouse, or both spouses, are not considered valid; then a Non-Master File Tax Code 20 account is established on NMF.[4]

IRS COMMENTS

We concur with the Taxpayer Advocate concerning the master file transaction codes and their impact on spousal relief. We have already started initiating changes to IDRS that respond to the Advocate's concerns. As she pointed out, currently the IRS splits the "modules" or accounts only after the relief request has been processed. Beginning January 2005, however, we will be able to do so as soon as the request for relief is filed. The joint module will be 'mirrored' to create two individual "modules" or accounts, with codes to indicate which module is that of the spouse seeking relief. The mirrored account will allow collection activity to continue on the non-requesting spouse. Each mirrored module will have the proper Collection Statute Expiration Date, Assessment Statute Expiration Date, adjustment actions, and payment application for each spouse.

TAXPAYER ADVOCATE SERVICE COMMENTS

While we agree that the proposed 'mirrored-module' process is a step in the right direction, we have concerns about the treatment of taxpayers, including the non-requesting spouses, in the process and procedure the IRS will use in separating joint modules into separate mirrored modules. Specifically:

- *When the mirrored module is established, the initial notice the IRS plans to issue is the Statutory Collection (CP-504) notice. This notice was not designed to notify taxpayers about adjustments or changes. We recommend that the IRS develop and use a notice that would inform taxpayers when their joint account has been mirrored into separate modules.*
- *With the establishment of a new mirrored balance due module, an Installment Agreement (IA) is systemically defaulted, and in some instances the Notice of Federal Tax Lien (NFTL) is systemically issued.[5] This occurs even when the IA is current. For this circumstance, we recommend that IRS establish procedures to both prevent the systemic issuance of the NFTL and to withdraw such liens in the event they are filed.*

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[4] Internal Revenue Manual 21.7.12.4.1.1, NMF Husband Only/Wife Only Assessment - Claims Filed; IRM 3.17.46.1.12(53), Glossary of Computer Terms; and IRM 3.27.68.1.22, Non-Master File - MFT Codes IDRS.

[5] Internal Revenue Manual 5.14.1.4.2 Notice of Federal Tax Lien and Installment Agreements (Rev. 07-01-2002).

- *When re-establishing the IA that was terminated through no fault of the non-requesting spouse, current IRS procedures allow an IRS employee to make a different determination on whether or not to file a NFTL, even if the IA is set up (including a manually monitored IA) under the same financial circumstances and terms and conditions of the initial IA.*[6] *When a module is mirrored, and the IA is re-established under similar terms and financial conditions as the IA defaulted when the module was mirrored, we recommend that the IRS add procedures requiring that the initial determination not to file an NFTL be followed through when the IA is re-established and to withdraw such liens in the event they are filed.*
- *The IRS is not concurrently updating the Examination Returns Control System (ERCS) to add MFT 31. The IRS uses ERCS to interface with the Master File, through IDRS, regarding the status and outcome of an audit. These modules cannot be split until the audit is completed. We recommend that the IRS update ERCS to include MFT 31.*

[6] Internal Revenue Manual 5.19.4.5.2 Lien Filing Determinations (Rev. 06-26-2001).

PROBLEM

TOPIC #15 MOST SERIOUS PROBLEM: CRIMINAL INVESTIGATION FREEZES

RESPONSIBLE OFFICIAL

Nancy Jardini, Chief, Criminal Investigation Division

DEFINITION OF THE PROBLEM

TAS case receipts for fiscal year 2003 reflect a substantial increase in queries from taxpayers whose accounts were controlled by the IRS' Criminal Investigation (CI) Fraud Detection Units.[1] The CI control, or "freeze," is a notation on the account that prevents the IRS from refunding an overpayment and alerts other IRS personnel that the account is under review for fraudulent schemes. CI is required to institute these controls to protect ongoing criminal investigations and maintain the potential to convict the perpetrators of the schemes. However, TAS has identified the following problems with the processes for handling such accounts:

- CI is currently not required to notify taxpayers that their return is under investigation, nor that the IRS will withhold their claimed refund until the probe is complete.
- Due to the potential for jeopardizing the investigation, and the real possibility of fraud, TAS is restricted and sometimes prohibited from resolving the accounts, even in hardship situations.
- Even with TAS intervention, the IRS may delay contact with the taxpayer for as long as one year.[2]

ANALYSIS OF PROBLEM

Criminal Investigation (CI) is charged with investigating criminal tax law violations for the IRS, in contrast to the IRS' compliance staff, which investigates civil tax issues.[3] CI's enforcement operation includes ten nationwide Fraud Detection Centers (FDCs), each located in or near an IRS campus (formerly called service center). The Fraud Detection Centers operate the IRS Questionable Refund Program and work to uncover refund fraud and identify methods of limiting further fraud for both paper and electronically-filed tax returns.

When CI suspects a fraudulent return has been filed, a CI freeze placed on the taxpayer's account prevents the release of a refund while the return is validated and potential fraud investigated. As resources permit, CI begins a sometimes lengthy data gathering phase. The actual duration varies. Wage income may be more quickly verified than self-employ-

[1] FY 2002 Taxpayer Advocate Management Inventory System (TAMIS) receipts reflect 5,541 Major Issue Code 474 (now obsolete) and Primary Core Issue Code 950 CI Cases. FY 2003 TAMIS receipts for Primary Core Issue Code 950 reflect over 15,249 cases. This represents a 175 percent increase in taxpayer contacts in this area. (15,249 - 5,541)/5,541 = 1.75.

[2] Returns determined to be "valid" are generally resolved more quickly. Indications of fraud require assignment to and investigation by a Special Agent or a referral to exam.

[3] Criminal Investigation Division, History of IRS Criminal Investigation, Publication 1918 (Rev. 7-2001).

ment income. Resolution also depends on the taxpayer's understanding of information requests and ability to respond quickly with the needed documentation.

Taxpayers anticipate the delivery of their refunds. The Form 1040 instructions inform them that direct deposit refunds from electronically filed returns may be delivered in as little as 10 days.[4] A later note for paper returns advises taxpayers to check with the IRS if four weeks have passed since filing and no refund is received.[5] However, when a CI freeze delays a refund beyond these normal processing times, the taxpayer's inquiry to IRS Customer Service will yield only a limited statement that the return is still under review. To protect investigations, IRS employees are not allowed to explain more specifically why the refund has not been released.

In all, the initial review may take several months, and release of a legitimate refund may take a year or more.[6] During this time, CI is not required to advise the taxpayer that their return is under investigation, nor that their refund will be frozen until the investigation is over. No other IRS function actively attempts to inform the taxpayer of the delay.

As weeks pass, some taxpayers seek TAS assistance. However, taxpayers who are not suffering an "economic hardship" must wait 180 days before requesting a Taxpayer Assistance Order.[7] While TAS will then provide an internal voice to petition CI for resolution of a case, the arrangement has significant shortcomings. First, it is TAS that issues a letter advising taxpayers that the IRS is reviewing their returns, and that the IRS office will contact them if additional information is needed.[8] This notice is long overdue by the time TAS is involved. Second, TAS assistance remains somewhat limited by the need to protect the investigation. The TAS case advocate will work with the taxpayer to provide CI with information required to validate the return, but cannot be entirely candid about the review. Finally, even with TAS help, release of the refund may take several months beyond the "silent period" that taxpayers without hardships must wait through to receive TAS assistance.

TAS has special concern for the innocent taxpayers caught in schemes devised by their tax preparers. Return preparer fraud generally involves the orchestrated preparation and filing of false tax returns using:

4 2002 1040 Instructions, Cat. No. 24811V, p. 4

5 Id. p. 13. Taxpayers should call after three weeks for electronically filed returns.

6 Treasury Inspector General for *Tax Administration, Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected,* Reference # 2003-10-094, March 2003, p. 8.

7 Internal Revenue Manual (IRM) 13.1.10.10.4 (rev. October 10, 2001): 90 day time frame extended to 180 days effective July, 2003. *See* IRC § 7811(a)(2) for a definition of significant hardship for purposes of a taxpayer assistance order.

8 Internal Revenue Manual (IRM) 13.1.10.10.5 (rev. October 10, 2001).

- inflated personal or business expenses,
- false deductions,
- unallowable credits or excessive exemptions,
- fraudulent tax credits, such as Earned Income Tax Credit (EITC), or
- stolen Social Security numbers (SSNs).

Taxpayers who find themselves involved in these schemes are at best liable for additional taxes and interest. At worst, they are subject to penalties and perhaps even criminal prosecution. Taxpayers who are not party to the schemes may still experience real hardships when their refunds are held because of an unfortunate choice of tax preparer. TAS will work with the taxpayer to collect the required documents to clear up the issue. However, TAS must then forward the information to CI, which still controls final resolution of the account. Throughout this process, TAS can only provide vague status reports to the taxpayer and encourage CI to act quickly.

Finally, even when the refund for one tax period is released, the CI control may stay on the taxpayer's account for up to two additional years. This subjects the taxpayer to review of their taxes each year until the control is removed.

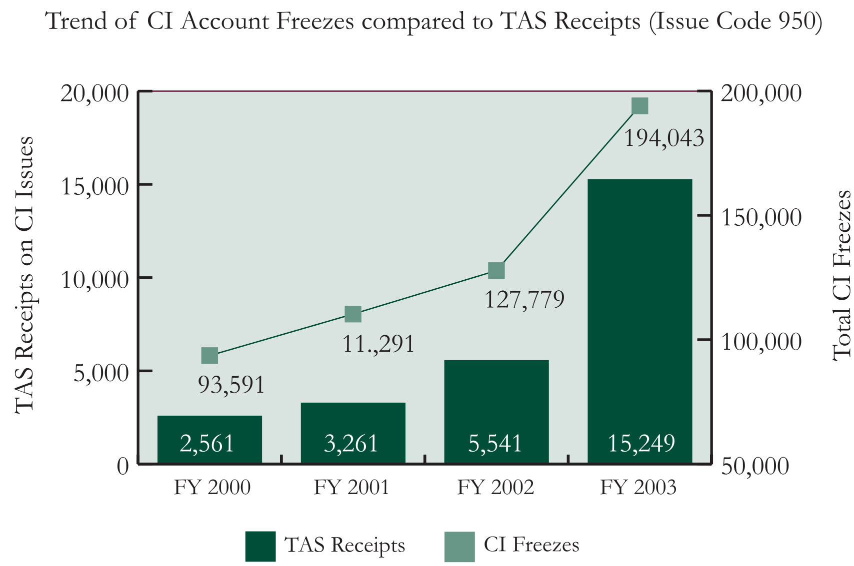
During fiscal year 2003, account problems escalated as the number of CI controlled accounts rose dramatically. Almost two hundred thousand taxpayers had accounts frozen by CI in FY 2003, up more than 50 percent from FY 2002.[9] CI related TAS case receipts also climbed, rising to almost three times the number of referrals received in FY 2002. Chart 1.15.1 suggests a correlation between the increase of accounts frozen by CI and the significant growth in TAS cases for which CI is determined to be the primary issue.[10] While CI reports a real increase in fraud and abuse, the National Taxpayer Advocate is concerned that a revision in the program to identify potentially fraudulent returns has produced a lower rate of accurate identification, resulting in a higher percentage of legitimate claims being delayed.[11]

[9] CI Freeze data provided by CI, November 5, 2003.

[10] *See* Appendix 1: TAMIS Cases CI issues (Primary Core Issue Code 950) represent seven percent of all FY 2003 cases.

[11] Criminal Investigation Division, FY 2002 Annual Business Report, "Refund Fraud Program," available at http://www.irs.gov. Data provided by CI indicates a 152 percent increase in total refund fraud from FY 2000 to FY 2003.

Chart 1.15.1, TAS Receipts and CI Freezes: FY 2000 Through FY 2003[12]



Incidental to the hardships taxpayers face, the increase has also required TAS to devote more resources to monitoring these cases and reporting to taxpayers. When taxpayers receive letters from TAS, they usually call the TAS toll-free telephone line, since this is the only contact number provided in connection with the missing refund. If a case cannot be quickly resolved, TAS may give the taxpayer a follow-up target date. If the CI review is not complete by that date, the taxpayer contacts TAS again. This situation may be repeated several times over the length of the CI investigation, while TAS continues to petition CI for action.

TAS and CI are currently negotiating a Service Level Agreement (SLA), similar to those between TAS and other IRS operating divisions and the Appeals division, to define procedures for handling accounts between the two functions. These agreements outline the procedures and responsibilities for processing TAS casework when the authority to complete case transactions rests outside of TAS. The lack of such an agreement with CI has impeded the exchange of information that could be used to clear non-fraudulent returns from CI's inventory.

The Taxpayer Advocate Service cannot ask Criminal Investigation to retreat from critical efforts to stem fraud. However, these efforts must be approached with a concern for the many taxpayers who will not be found fraudulent. For these taxpayers, basic communication and a speedy return of legitimate refunds should be an IRS - and CI - priority.

[12] Taxpayer Advocate Management Information System (TAMIS) FY 00-02 from "MI Code Info FYs 00, 01, 02." Receipts reflect Major Issue Code 474, now obsolete. FY 03 from TAMIS data, TAS case receipts for fiscal year 2003, generated October 24, 2003. Primary Core Issue Code 950. CI Freeze data provided by CI, November 5, 2003. CI totals are cumulative and include new and existing account controls.

IRS COMMENTS

The IRS agrees with the National Taxpayer Advocate that speedy resolution of potentially fraudulent returns should be a priority. To that end, the IRS created the Questionable Refund Program (QRP) to identify fraudulent returns, stop associated refunds and identify criminal cases for referral to CI's Field Offices. Our goal has always been to do this in an efficient and judicious manner.

However the significant increase in volume and the income verification part of this process have combined to make it more prolonged than would be preferable. Fraudulent filings have increased 152 percent from fiscal year 2000 to October 2003, to more than 88,600 returns. This increase alone puts IRS resources under a severe strain. Added to this is the fact that current FDC procedures require employer verification of the information on the W-2 attached to a suspected fraudulent return. These factors combine to make the entire process very time consuming. Despite these challenges, the QRP program has been successful in identifying in excess of $1.876 billion in fraudulent refunds from processing year 2000 through September 2003. A high percentage of the fraudulent refunds have also been stopped from being paid to the perpetrators of these schemes.

The principal component of the fraudulent returns was electronically (ELF) filed. These ELF fraudulent returns increased more than 459 percent to in excess of 54,700 as of October 2003. The QRP identification program has been refined by the implementation of a Data Mining model. This model has produced a lower workload and resulted in a higher detection rate of fraudulent returns. In 2003, the detection rates ranged from 78 percent to 82 percent of identified fraudulent returns. Based on a review of the TAS receipts, approximately 61 percent of the inquiries were associated with fraudulent refunds. This indicates that a large percentage of the TAS queries are coming from fraudulent filers. This is unavoidable based upon the current system configuration.

We are, however, taking steps to make this process more efficient and therefore ensure a more rapid resolution for both the individual taxpayer and the IRS. The IRS has developed two programs that should assist in reducing the burden associated with verification. We will assist in organizing the employer information to reduce the number of times an employer has to be contacted. However, the best solution would include a systemic verification of wages upon the filing of every return. Currently, information exists within Health and Human Services (HHS) in the form of the National Directory of New Hires (NDNH) database that would allow for a systemic solution to a large portion of the verification problem. The current law allows for the use of this data for returns claiming earned income tax credit (EITC). IRS is seeking a legislative proposal to allow the information already collected by HHS to be provided to IRS at no cost and be used for all compliance purposes.

With regard to the Advocate's issue on withholding refunds, it is important to note that there is a significant distinction between QRP and the Return Preparer Program (RPP) in the area of freezing the accounts. In most instances, the returns associated with QRP cases are totally fraudulent. This requires the freezing of the refunds to stop the payment of the fraudulent refunds in the current and subsequent years. Returns associated with RPP cases usually have some element of validity to them and have been manipulated to derive a larger refund for a real taxpayer. There are very few cases where all returns associated with an abusive return preparer are frozen. There are also very few instances when returns associated with abusive RPP cases are frozen for multiple years.

We also agree with the Advocate that the lack of a Service Level Agreement (SLA) impeded exchange of information. The SLA was necessitated because of the reorganization and the way TAS inquiries are handled. Previously, local service center (campus) agreements had been in place and were working effectively. CI is awaiting a final version of the SLA so that it can be reviewed and finalized for the 2004 processing season.

TAXPAYER ADVOCATE SERVICE COMMENTS

The Taxpayer Advocate Service acknowledges the significant accomplishments of CI against those who would manipulate IRS systems for fraudulent purposes. Aggressive efforts to curb both individual and preparer promoted refund schemes are vital to continued equitable tax administration. However, the process of investigation should reflect the customer focus engendered in the IRS restructuring.

Investigation related delays are not simply the just rewards of fraud. Consider the numbers provided in the IRS comments. While noting that a portion of TAS cases involved fraudulent claims, the IRS also demonstrated that the investigation process also delayed the refunds of more than 5,600 valid returns.[13] *Moreover, the IRS does not know from the outset which of the nearly 200,000 frozen claims will eventually be validated.*[14] *Each investigation has the potential to conclude with the release of a properly claimed refund to a family who may be depending on that money.*

Given the financial impact of a delayed refund, standard courtesy should not be withheld until the investigation is complete. For this reason we assert that taxpayers should be notified whenever the IRS will not release a claim within the normal processing time frames. As noted in the report above, a delayed refund does not go unnoticed by taxpayers. An IRS letter declaring the delay would not pose any greater risk to an investigation than the response already given to a taxpayer's telephone inquiry. Instead, a notice could provide a well-considered message that may forestall unnecessary telephone inquiries, acknowledge the established claim, provide a follow-up time frame, and remind the taxpayer of refund interest provisions.

13 TAMIS data: In FY 2003, TAS closed 14,483 Issue Code 950 cases, 5,662 with "relief provided."

14 *See* Chart 1.15.1. Total accounts frozen in FY 2003: 194,043.

TAS also looks forward to the resumption of effective interactions between case advocates and CI personnel under a finalized Service Level Agreement. A proper result will enable TAS to facilitate expedited validation of legitimate claims without impeding IRS criminal enforcement efforts. To maximize the productivity of TAS/CI interaction, TAS also anticipates collaboration to provide case advocates with training on current scheme trends and related CI projects.

PROBLEM

TOPIC #16 MOST SERIOUS PROBLEM: APPEALS INVENTORY DELAYS

RESPONSIBLE OFFICIAL

Dave Robison, Chief Appeals

DEFINITION OF THE PROBLEM

Despite several initiatives to eliminate delays in the Office of Appeals' inventory of non-docketed cases, inventory problems still exist. Taxpayers and their representatives continue to experience delays in:

- The time between requesting an Appeals conference and the first contact from Appeals;
- The lead time required to schedule an Appeals conference or hearing; and
- The amount of time it takes to complete the Appeals process.

The delays in Appeals cases can result in increased interest and penalties for taxpayers.

ANALYSIS OF PROBLEM

The mission of the Office of Appeals is to resolve tax disputes impartially and without litigation. The Office of Appeals provides an independent administrative review of the tax agency's determinations and actions.

Appeals instituted balanced measures in fiscal year 2000, incorporating a focus on customer satisfaction as well as business results and employee satisfaction.[1] These measures enabled Appeals to identify significant problems such as the length of time it takes to complete the Appeals process, the time needed to schedule a conference, the length of time required for taxpayers to hear from Appeals, and continual delays in resolution for all types of cases.

Analysis of Appeals Work Flow

The Office of Appeals' inventory is divided between docketed and non-docketed cases.[2] Table 1.16.1 provides an analysis of Appeals' inventory volume, receipts and closures of both docketed and non-docketed cases.[3]

[1] The IRS Reform and Restructuring Act of 1998 required the IRS to develop balanced measures of performance. See Treas. Reg. §801.1 through 901.6 (These regulations implement provisions for §§1201 and 1204 of RRA 98).

[2] A docketed case involves a taxpayer who has petitioned US Tax Court and is scheduled to the court docket. Non-docketed cases is one that arises from IRS administrative procedure, including appeals form Offers in compromise or refund claims.

[3] Extracted from Appeals Centralized Database Systems FY00 - FY 03 and UniStar Reports, Table 11 and selected statistics, compiled by the Office of Appeals Tax Policy and Procedure, received via e-mail 11-26-03.

Table 1.16.1, Appeals Historical Data

	FY97	FY98	FY99	FY00	FY01	FY02	FY03
Receipts	76,684	65,434	58,679	55,431	68,198	76,397	98,378
Non-Docketed	54,753	48,482	43,513	44,454	57,700	66,106	83,918
Docketed	21,931	16,592	15,166	10,977	10,498	10,291	14,460
Closures	75,331	71,918	61,507	55,088	54,748	68,015	84,677
Non-Docketed	50,998	49,120	41,878	39,181	43,394	56,077	70,167
Docketed	24,333	22,798	19,629	15,907	11,354	11,938	14,510
Inventory Totals	59,329	51,143	47,461	46,519	58,968	66,174	79,213
Non-Docketed	33,321	29,350	28,524	30,405	43,348	50,185	61,094
Docketed-Appeals Judicated	16,625	13,216	11,196	7,662	8,934	9,075	10,901
Docketed-Counsel Judicated	9,383	8,577	7,741	8,452	6,686	6,914	7,218

Appeals' receipts declined from fiscal years 1997 through 2001. The incoming inventory reflects more non-docketed than docketed cases. Both docketed and non-docketed case receipts declined steadily between FY 1997 and FY 2000, then began to increase in FY 2001 and grew through FY 2003. Receipts in FY 2002 were virtually equal to receipts in FY 1997, but Appeals closed 7,316 fewer cases in FY 2002 than in FY 1997. Closures also followed a downward trend from FY 1997 through FY 2001 but increased in FY 2002 and FY 2003.

Since the enactment of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98),[4] Appeals' non-docketed workload has grown, including an increasing volume of campus (service center) and Collection cases. Table 1.16.2 below illustrates the shift from a workload consisting mostly of examination-based cases to campus (service center) and collection cases over the past six fiscal years.[5] Table 1.16.3 shows a steady decline in docketed cases from examination sources and an upward trend beginning in campus sources. The table also shows that closures of docketed cases always outpaced receipts.[6]

[4] Pub. L. No. 105-206.

[5] Table 17, Appeals Workload, by Status and Source, FY 1998 through 2002, IRS Data Book, Publication 55b, and Extracted from Appeals Centralized Database Systems FY00 - FY 03 and UniStar Reports, Table 11 and selected statistics, compiled by the Office of Appeals Tax Policy and Procedure, received via e-mail 11-26-03.

[6] Id.

Table 1.16.2, Non-Docketed Appeals Workload

Appeals Non Docketed	Cases Received	Cases Closed	Exam Cases Rcvd*	Collection Cases Rcvd*	Campus Rcvd*
FY 1998	48,482	49,120	23,139	9,174	16,169
FY 1999	43,513	41,878	14,758	11,278	17,477
FY 2000	44,545	39,181	10,677	11,719	21,686
FY 2001	57,700	43,394	9,318	17,522	30,860
FY 2002	66,106	56,077	9,748	18,356	38,002
FY 2003	83,918	70,167	No Data	No Data	No Data

* Exam sources include field, office examination and CEP.
Collection sources include field collection duties.
Campus sources are types of work done at the campus, including earned income tax credit and automated underreporter exams, offers in compromise, etc.

Table 1.16.3, Docketed Appeals Workload

Appeals Docketed	Cases Received	Cases Closed	Exam Cases Rcvd*	Collection Cases Rcvd*	Campus Rcvd*
FY 1998	16,952	22,798	10,230	None	6,722
FY 1999	15,166	19,629	6,505	None	8,661
FY 2000	10,977	15,907	5,332	69	5,310
FY 2001	10,498	11,354	3,457	15	7,026
FY 2002	10,291	11,938	2,979	10	7,302
FY 2003	14,460	14,510	No Data	No Data	No Data

* Exam sources include field, office examination and CEP.
Collection sources included field collection duties.
Campus (Service Center) sources are types of work done at the campus, including earned income tax credit and automated underreporter exams, offers in compromise.

This changing inventory has resulted in increased cycle times,[7] unmanageable inventories and unprecedented customer communication issues. As a result, Appeals has explored ways to eliminate delays in the process.

Appeals Inventory and Cycle Time

Over the past six years, Appeals tracked inventory and cycle time to determine the effect of new work streams on receipts and the time required to work these cases. Table1.16.4 represents Appeals' cumulative cycle time and staffing for fiscal years 1997 through 2003.[8]

[7] Cycle time is defined as the average days applied to a case. Appeals tracks cycle time only for non-docketed inventory.

[8] Extracted from Appeals Centralized Database Systems FY00 - FY 03 and UniStar Reports, Table 11 and selected statistics, compiled by the Office of Appeals Tax Policy and Procedure, received via e-mail 11-26-03.

Table 1.16.4, Appeals Cycle time and Staffing

	FY97	FY98	FY99	FY00	FY01	FY02	FY03
Appeals Cycle Time (Days) Non-Docket	220	210	223	222	224	279	285
Staffing[9]	1062	1072	1054	977	983	1058	1023
Total Receipts	76,684	65,434	58,679	55,431	68,198	76,397	98,378

Cycle time for non-docketed cases has increased by 30 percent from 1997 to 2003. During fiscal years 1998, 1999 and 2000, total case receipts declined while the cycle time for working them increased and staffing was reduced. Although staffing with direct contact on cases rose significantly between fiscal years 2001 and 2003, receipts and cycle time also increased. The staffing for fiscal years 1997 and 2002 are approximately equal, as are receipts, yet the cycle time for FY 2002 is 59 days longer than 1997. It appears that Appeals' cycle time continues to grow regardless of staff and receipts, which may indicate that neither receipts nor staffing levels are the cause of the increased cycle time.

The cycle time for Collection Due Process cases increased throughout FY 2002, and then decreased by approximately six percent in fiscal year 2003.[10] Offer in compromise (OIC) cycle time also decreased between FYs 2002 and 2003. While cycle times have fallen in these programs, they have increased in other work streams.

Table 1.16.5, Cycle Time FY 2002 and FY 2003

Cycle days	FY 02	FY 03
CDP (Collection Due Process)	274	253
OIC (Offer in Compromise)	331	313
INNSP (Innocent Spouse)	384	446
POST PEN (Post Penalty)	166	194
Exam/TEGE	391	372
Other	No Data	238

Table1.16.6 shows receipts of non-docketed appeals cases by work streams.[11] Both collection due process and offer in compromise cases have increased significantly since fiscal year 2000.

[9] Those included in staffing would be Appeals Officer (AO); Settlement Officer (SO); Customer Service Outreach (CSO); Appeals Quality Measurement System Reviewer (AQMS); and SCRs.

[10] Appeals Inventory Reports, FY 2003, run date 10/27/03 and ACDS Numbers for FY 2002, compiled by the Office of Appeals Tax Policy and Procedure.

[11] Extracted from Appeals Centralized Database Systems FY00 - FY 03 and UniStar Reports, Table 11 and selected statistics, compiled by the Office of Appeals Tax Policy and Procedure, received via e-mail 11-26-03.

Table 1.16.6, Non-Docketed Receipts by Work Stream

Category [12]	FY00	FY01	FY02	FY03
CDP	6,883	19,019	26,656	31,837
OIC	4,358	6,837	7,393	16,858
INN SP	No Data	No Data	3,451	3,960
PENAP	No Data	No Data	12,091	12,556
CIC	No Data	No Data	517	592
IC	No Data	No Data	730	605
EXM/TEGE	No Data	No Data	10,400	12,616
OTHER	No Data	No Data	4,868	4,894
Total	**44,454**	**57,700**	**66,106**	**83,918**

Appeals Balanced Measures

In fiscal year 2000, Appeals implemented a balanced measurement approach and established measures on:

- Customer Satisfaction;
- Employee Satisfaction;
- Business Results - Quantity; and
- Business Results - Quality.

These balanced measures are used to develop organizational goals, assess programs, identify improvement opportunities, and plan for future challenges.

The business results measures established in FY 2000 included two quality and two quantity measures.[13] The first quality measure is a score from the Appeals Quality Measurement System (AQMS) based on a review of a statistically valid sample of closed cases. The second quality measure focused on timeliness by tracking closed case cycle time for non-docketed cases. The two quantity measures were Customer Outreach activities and total closed cases.

The customer satisfaction data is obtained through a quarterly survey by an outside firm of overall satisfaction with the Appeals process. The AQMS Reviewer's Alert dated March 2003 confirmed what taxpayers have told Appeals in surveys - the appeals process takes too long. The AQMS review staff stated that hearing officers appear to be responsible for the delays and did not take appropriate follow-up actions in many Appeals cases.[14]

[12] Definition of categories: CDP (Collection Due Process); OIC (Offer in Compromise); INN SP (Innocent Spouse); PENAP (Penalty Appeal); CIC (Coordinated Industry Case); IC (Industry Case); EXM/TEGE (Exam and Tax Exempt Government Entities).

[13] FY 2000 Appeals Strategic Plan.

[14] AQMS Reviewers Alert, March 2003.

Table 1.16.7 Average Ratings by Standard - FY2002 vs. 2001

		Standard 1 Fair Treatment of Taxpayer	Standard 2 Quality of Decision	Standard 3 Accuracy of Computation	Standard 4 Appeals case memo	Standard 5 Time span and time applied	Standard 6 Procedural compliance	Overall Average Rating
General Appeals	FY 02	81%	92%	95%	87%	45%	89%	81%
	FY 01	81%	91%	97%	85%	57%	92%	84%
Large & Mid-Sized Business	FY 02	90%	94%	79%	82%	62%	87%	82%
	FY 01	86%	93%	97%	83%	60%	91%	84%

A 2003 customer satisfaction survey indicates that 68 percent of dissatisfied customers want to hear from Appeals within 30 days of their cases arriving in Appeals, and 67 percent think the entire case should be resolved within two months. [15] Some of the survey's findings are listed below.

- **Length of the Appeals process**
  Of 369 customers, 38 percent indicated that it took 184 to 365 days for the entire process (from the time the taxpayer requested an Appeal through closure) and 30 percent stated it took 366 to 730 days. The average rating on a scale of 5 was 2.96.
- **Time before first contact**
  Of 365 customers, 33 percent indicated that it took 91 days or more to assign the case to a hearing officer from the time an appeal was requested.
- **Time it takes to schedule an Appeals conference**
  The average rating for this element 3.11 out of a possible 5. Of the 18 survey questions regarding satisfaction, this area ranked next to last.[16]

Impact of CDP Hearings on Appeals Inventory

Congress created the Collection Due Process program in 1998 to provide taxpayers an opportunity for a review of their cases by an independent officer of the IRS. The legislation established an informal adjudication procedure designed to ensure due process when the IRS seeks to collect taxes by levy and/or files a lien to protect its interest.[17]

Not surprisingly, the number of CDP cases is growing. Since CDP is derived from IRS compliance initiatives, CDP caseload increases as the IRS conducts more collection activi-

[15] Pacific Consulting Group, *Customer Satisfaction Survey 2003*: Appeals National Report, p. 5.

[16] Id; *see also* satisfaction rating page 14 &15, appendix C-4, appendix C-3.

[17] Levy is the IRS's administrative authority to seize a taxpayer's property to pay the taxpayer's tax liability. RRA 98, Act Section 3401(a), adding IRC § 6320; Act Section 3401(b) adding IRC § 6330.

ty and greater examination activity results in more balances due from taxpayers. Delays can be expected to continue, particularly since Appeals closures have lagged behind receipts for each fiscal year.[18]

Table 1.16.8, CDP Receipts and Closures

12-Month Period Ending	CDP Case Receipts	CDP Case Closures
(first year of program)	6,892	No Data
9/30/2001	19,119	8,065
9/30//2002	26,666	25,293
9/30/2003	31,848	27,467

In 2001, the Treasury Inspector General for Tax Administration (TIGTA) noted that Appeals officers did not always timely contact taxpayers after CDP cases were assigned and case files showed periods of unexplained inactivity.[19] As a result, the Office of Appeals established procedures stating that CDP taxpayers will be sent acknowledgement letters no later than 30 days after receipt by Appeals.[20]

Despite improvement in some Appeals processes during fiscal years 2002 and 2003, taxpayers with CDP cases are still experiencing delays. A 2003 TIGTA report reiterated the need to concentrate on timeliness in contacting the taxpayer and discussing the CDP case as well as scheduling a hearing. TIGTA recommended that the Internal Revenue Manual (IRM) require this action within 30 days of CDP case assignment.[21]

Impact of Campus Offers In Compromise and Exam/Tax Exempt Government Entities (TEGE) Inventory

The increase in Offer in Compromise and Exam/TEGE receipts over the past two fiscal years, is displayed in Table1.16.9. Both of these work streams have experienced a substantial increase, and have contributed to the overall growth of Appeals inventory.[22]

[18] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 110, and Appeals Inventory Report (AIR) cumulative through 9/30/03.

[19] Treasury Inspector General for Tax Administration, *Taxpayer Service on Lien and Levy Appeals could be Further Improved*, Reference #2001-10-068, May 2001.

[20] IRM 8.7.2.3.2, November 13, 2001.

[21] Treasury Inspector General for Tax Administration, *Appeals Could Take Additional Actions to Improve the Timeliness of Collection Due Process*, Reference # 2003-10-202, September 2003.

[22] Appeals Inventory Report (AIR), dated 9/30/2002 and 9/30/2003.

Table 1.16.9 Appeals OIC & EXAM/TEGE Receipts

Fiscal Year	OIC Receipts	Exam/TEGE Receipts
9/30/2002	7,392	20,309
9/30/2003	16,861	26,607

Appeals Ending Inventories

Table 1.16.10, shows the volume of non-docketed cases received and cases closed for fiscal years 1998 through 2003 as well as the fiscal year ending inventory level. For the first three fiscal years, Appeals realized steady inventory reductions as receipts declined and closures kept pace with receipts. From fiscal years 2001 through 2003, however, the number of Appeals cases closed failed to keep up with increasing receipts. Thus, in FY 2001, the ending inventory of cases grew by 12,019 or 38 percent over the previous year. The ending inventory for FY 2002 increased by 6,837, a 16 percent jump. The ending inventory for FY 2003 was 63,936 cases, a 27 percent increase (13,751 cases) from the year before.[23]

Table 1.16.10 Beginning and Ending Inventories for Appeals Non-Docketed

	Beginning Case Inventory (Oct 1)	Cases Received	Cases Closed	Ending Case Inventory (Sept 30)	Ending Inventory Change from Prior Year
FY 1998	33,321	48,482	49,120	29,350	
FY 1999	29,350	43,513	41,878	28,524	-03%
FY 2000	28,524	44,082	39,087	31,329	+10%
FY 2001	31,329	57,700	43,394	43,348	+38%
FY 2002	43,348	66,106	56,077	50,185	+16%
FY 2003	50,185	83,918	70,167	63,936	+27%

Table1.16.11 indicates the volume of docketed cases received and cases closed for fiscal years 1998 through 2003. The ending inventories steadily declined in FY98 and FY99 before beginning to increase in FY 00. In fiscal year 2003, there was a large increase in cases received, which is reflected in the 27 percent increase in ending inventory.[24]

[23] IRS Data Book, Publication 55b, Table 17 Appeals Workload, by Status and Source, FY 1998 - FY 2002, and Extracted from Appeals Centralized Database Systems FY00 - FY 03 and UniStar Reports, Table 11 and selected statistics, compiled by the Office of Appeals Tax Policy and Procedure, received via e-mail 11-26-03.

[24] Id.

Table1.16.11, Beginning and Ending Inventories for Appeals Docketed

	Beginning Case Inventory (Oct 1)	Cases Received	Cases Closed	Ending Case Inventory (Sept 30)	Ending Inventory Change from Prior Year
FY 1998	26,008	16,952	22,798	21,793	
FY 1999	21,793	15,166	19,629	18,937	-13%
FY 2000	18,937	10,977	15,907	16,114	-15%
FY 2001	16,114	10,498	11,354	15,620	-04%
FY 2002	15,620	10,291	11,938	15,989	+02%
FY 2003	15,989	14,460	14,510	18,119	+13%

Inventory aging for non-docketed cases, remains an area of concern. Table 1.16.12 shows inventory aging for FY 2003, categorized by work stream. Only 27 percent of CDP cases are older than six months. This reduction of CDP cases over six months old reflects the strategic emphasis Appeals has placed on reducing CDP cycle time.[25]

Table 1.16.12, Work stream Non-docketed Inventory Aging

Inventory Aging Non Docket	CDP	OIC	INNSP	POSTPEN	EX/TEGE	Other
90 days or less	7054	3151	783	2415	2510	680
90 -180 days	6457	3774	820	1655	2641	606
181 - 365 days	3694	2955	1262	1092	3387	794
366 - 730 days	939	1122	970	331	2750	692
730 or more days	306	379	203	93	722	185
Totals	18450	11381	4038	5586	12010	2957
Percentage over six months	27%	39%	60%	27%	57%	57%

As previously noted, when resources are used to reduce the cycle time on one category of cases, such as CDP, the percentage of cases older than six months increases in other areas.

The Future of Appeals Inventory

The IRS' renewed focus on compliance will have a profound impact on Appeals' inventory. The Small Business/Self Employment (SB/SE) and Wage & Investment (W&I) divisions are both increasing their compliance initiatives processes. The increased emphasis on fighting tax schemes and abusive trusts, collection contracting, increased COIC dispositions and major campus (service center) compliance programs (e.g. Automated underreporter (AUR), Automated Substitute for Return (ASFR), Correspondence Exam), will generate a greater number of and/or more complex accounts. Appeals inventories are beginning to show increases in FY 2003 throughout all work streams, including docketed receipts. In addition to anticipating workload shifts from the operating divisions,

[25] Appeals Inventory Report (AIR) for period ending September 30, 2003.

Appeals must plan to receive work from other functions such as the Office of Chief Counsel and the Taxpayer Advocate Service.

Appeals has lagged behind the rest of the IRS in adjusting to its reorganization and in predicting and planning for changes in inventory workstreams. This lack of foresight and flexibility has resulted in increased cycle time and processing delays as well as customer dissatisfaction.

IRS COMMENTS

The Advocate has raised three key issues concerning the status of Appeals inventory.

1. Inventory problems exist which are shown in the length of time it takes to complete the Appeals process, the time needed to schedule a conference, the length of time required for taxpayers to hear from Appeals, and continual delays in resolution of all types of cases.
2. The lack of timely contacting of taxpayers as identified in the TIGTA report for 2001 and 2003 on CDP cases.
3. That Appeals lacks foresight and flexibility. "Appeals has lagged behind the rest of the IRS in adjusting to the Service's reorganization and in predicting and planning for changes in inventory work streams. This lack of foresight and flexibility has resulted in increased cycle time and processing delays as well as customer dissatisfaction.

We agree with the Taxpayer Advocate's first two issues-they are ours as well. We do believe, however, that we have put in place various strategies and process changes to address these major concerns. We also believe our recent track record of improving cycle time for our CDP and OIC work streams and applied time in all work streams further indicates our success at addressing these issues.

We disagree with the Advocate's conclusion that "Appeals lacks foresight and flexibility". We believe we have taken and continue to take steps to address our inventory and timeliness concerns.

The Appeals organization that existed in 1997 is dramatically different from the Appeals of today. The Advocate's reliance on a 1997 comparison while accurate does not tell the whole story. RRA '98 so significantly changed the types of work that Appeals considers that reliance on such comparisons is not meaningful. During the period FY 2000 to FY 2003 Appeals' cases receipts skyrocketed by 77 percent (55,431 to 98,378) while our technical staff only increased 4.7 percent (977 to 1023). Appeals' cycle time continues to grow because receipts have so dramatically outpaced staffing. Appeals has made significant productivity gains in the last two years as evidenced by our 53.7 percent increase in disposals during this same timeframe (55,088 to 84,677) but not enough to keep inventories and cycle time from growing.

TABLE 1.16.13, APPEALS CYCLE TIME, STAFFING & RECEIPTS

	FY97	FY98	FY99	FY00	FY01	FY02	FY03
Appeals Cycle Time (Days) Non-Docket	220	210	223	222	224	248	267
Staffing AO/ SO / CSO/ SCR/ AQMS[26]	1062	1072	1054	977	983	1058	1023
Total Receipts	76,684	65,434	58,679	55,431	68,198	76,397	98,378

The creation of the Collection Due Process case so dramatically changed our case receipts from 14 percent. Collection cases in FY 1997, none of which were CDP, to over 50 percent Collection cases in FY 2003, most of which are CDP - that all of our new technical hires since 2000 have been Collection personnel and the vast majority of our training has focused on Collection related issues since the passage of RRA 98.

In addition, the nature of our work has changed so fundamentally that it has caused us to begin the transformation of our organization from one exclusively field based to one where a significant portion of our technical resources will be located in a Campus environment. All this change required Appeals to review their processes. As a result of process changes, productivity increased 68 percent from FY 2000 to FY 2003.

The significant changes brought by RRA '98 have created complex and difficult challenges, which Appeals has and is overcoming. We believe the strategies and actions we state below demonstrate Appeals possesses both foresight and flexibility - not the lack of them.

Appeals began to take multiple actions to reduce the length of the Appeals process in FY 2002 which continue today.

- Re-examining each of our major work streams to develop models that work for CDP, OIC, innocent spouse, and Campus examination work, including case processing

[26] Historical Data Report 1994 through 2003, compiled by Director, Tax Policy & Procedure, Appeals, dated 11/26/03.

Cycle Time Footnote: Beginning in FY 2003, the definition for nondocketed cycle time has changed. The new definition includes cases that were previously excluded from the cycle time measure computation - Appeals issued Statutory Notices (including CDP determination letters). The cycle time for FY 2002 was restated for comparability. The cycle time using the new definition was 279 in FY 2002 and 285 in FY 2003. The cycle time shown above is computed consistently for all periods.

- Early intervention for CIC, IC, tax shelters, and OIC
- Centralizing appropriate work in campus environment
- Establishing feedback loops with the operating divisions
- Establishing Advisory Councils

Through our emphasis on process improvements, Appeals has indeed become more efficient. The results of these efficiencies can be found in the table below. Here we find that in the last year alone, we have improved the time it takes to work cases in every work stream. This includes a six percent reduction in applied time in CDP work and a 21 percent reduction in applied time in OIC work. These reductions are partly due to the benefits of our extensive Collection training program, which we had undertaken since the inception of RRA 98. That we have been able to make gains in both cycle time and applied time in recent years is as a result of that significant training effort.

TABLE 1.16.14, APPEALS TIME PER CASE

	Time per case by Category of Work							
	CDP	OIC	INNSP	PENAP	CIC	IC	EX/TEGE	OTHER
FY 2002	12.22	16.35	18.96	5.04	326.65	72.47	21.48	11.85
FY 2003	11.54	12.92	16.78	5.02	239.94	69.56	17.50	10.90
Change	-0.68	-3.43	-2.18	-0.02	-86.71	-2.91	-3.98	-0.95
%	-6%	-21%	-11%	0%	-27%	-4%	-19%	-8%

Principally through significant training efforts and increased inventory management initiatives such as specialization, we have seen some improvement in our CDP and OIC cycle time. We believe the roll out of our Campus operations will enhance our ability to maintain these improvements and devote greater attention to improving the cycle time in our other work streams.

TABLE 1.16.15, CYCLE DAYS

Cycle days	FY'02	FY'03
CDP (Collection Due Process)	274	253
OIC (Offer in Compromise)	331	313
INNSP (Innocent Spouse)	384	446
POST PEN (Post Penalty)	166	194
Exam/TEGE	391	372
Other	219	238

Appeals determined that a Campus strategy was central to creating significant improvements in our operations. Centralizing certain work in campus operations will free up the Appeals field operations to concentrate on the more complex cases. This will improve the taxpayers' experience with Appeals and shorten the time their cases remain unresolved.

We made significant headway in implementing this strategy during FY 2003. Hiring and some training will be completed for 3 campus operations in Brookhaven, Covington and Fresno by January '04. Appeals anticipates having a total of 350 employees in campus locations, specializing in CDP, OIC, Penalty Appeals, Innocent Spouse, and Campus Exam cases.

Each campus will specialize in particular types of cases. The campus inventory will be the less complex work that originates in the campus. This strategy will allow us to specialize in our work assignment practices and standardize processing procedures. It will also allow us to retain our focus on individual taxpayer's issues and concerns - just in a more efficient manner. We believe our campus strategy will allow us to meet both our "service to each taxpayer" and our "service to all taxpayers" objectives and produce the desired results beginning this fiscal year.

The strategies we have outlined have required significant planning and foresight. They have required that we look at ourselves critically and produce a different Appeals structure and organization than the one in existence. These adjustments in strategy and implementation demonstrate the continuing flexibility of Appeals.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes that Appeals has undertaken initiatives to implement certain priorities to help reduce the influx of collection type cases. She also understands that the enactment of the IRS Restructuring and Reform Act of 1998 (RRA 98) brought significant changes to Appeals and that they have worked hard in addressing these problems. Moreover, she supports Appeals in its training program.

However, RRA 98 was enacted in July 22, 1998. It has taken Appeals five years to adapt with the fact that Congress changed its workload and directed that it be actively involved in collection cases. Only now is Appeals adjusting its staffing in order to address the change in its workload created by RRA 98. In the meantime, the IRS has successfully implemented the significant processing changes to "innocent spouse" determinations as well as two significant advance payments of child tax credits and a complete reorganization of it way of doing business with taxpayers.

This slowness in Appeals' response to a clear Congressional directive forms the basis for the National Taxpayer Advocate's observation that Appeals lacks foresight and flexibility in program design. The National Taxpayer Advocate does not understand why Appeals focused on the problems created by the large increase in collection cases rather than on managing the changing inventory. The rest of the IRS also received mandates and had to adjust to the provisions of RRA 98. They have accepted the challenge, planned, and performed accordingly.

The National Taxpayer Advocate agrees that receipts from FY 2000 to FY 2003 skyrocketed, but does not understand why Appeals did not plan for the growth in the CDP program and adjust its staffing and training sooner. In its response, Appeals points to significant productivity gains in the last two years. Why did it take so long? Productivity should have increased greatly between FY 1997 to FY2000 when receipts declined and staff remained constant. The National Taxpayer Advocate is concerned that Appeals is only focused on one work stream. IRS plans to increase enforcement efforts. Appeals needs to anticipate the increase in cases from other work streams and plan for the change now - rather than react to inventory problems once they occur.

The growth in Appeals CDP cases from FY 2000 to FY2003 is based on the statutory procedure mandated in RRA 98. However, Appeals workload increased in several other workstream categories during this same time period and was avoidable. For example, Offer in Compromise (OIC) cases more than doubled between FY 2002 and FY 2003 and Appeals should be working with OIC to determine why this is happening. Appeals has taken steps to address only the collection issue problems, which have been examined and re-examined since fiscal year 2000. While receipts for collection cases are a majority of the type of work Appeals receives, other work streams are beginning to increase. Appeals should work with the IRS to determine why increases are occurring in the various workstreams. Either the IRS is not getting the right answer the first time or there is a real disagreement and Appeals should take a fresh look. Unless Appeals understands why workstreams are increasing, it cannot effectively plan for or manage its inventory.

RECOMMENDATIONS

The National Taxpayer Advocate concurs with the recent Treasury Inspector General for Tax Administration (TIGTA) report dated September 2003, recommending that Appeals establish a thirty-day timeliness standard for Collection Due Process (CDP) cases. In addition, the National Taxpayer Advocate recommends that other follow-up timeframe standards be developed for Appeals cases. This will ensure that taxpayers are notified initially as well as provided continued contacts throughout the development of the case. Future customer satisfaction surveys may then reflect a more favorable response, since the customer is being kept informed of the progress of his or her case.

A continued review of the centralization process at the campus levels is needed to ensure that centralization continues to reduce and refine the time on case and inventory levels. The National Taxpayer Advocate recommends that the Appeals Quality Measurement System (AQMS) continue its reviews on standard five, timeliness, on a monthly or quarterly basis. The timeliness standards need to be incorporated into the Internal Revenue Manual, so that hearing officers are responsible for adhering to them. Theses standards can then be reviewed continually to develop trends and monitoring of compliance guidelines.

The National Taxpayer Advocate appreciates the actions taken by Appeals and its continued commitment in helping to reduce the overall inventory of cases.

PROBLEM

TOPIC #17 MOST SERIOUS PROBLEM: FEDERAL TAX DEPOSIT (FTD) PENALTY

RESPONSIBLE OFFICIALS

Henry O. Lamar, Commissioner, Wage and Investment Division
Dale Hart, Commissioner, Small Business/Self-Employed Division

DEFINITION OF THE PROBLEM

Federal Tax Deposit (FTD) requirements for employment taxes present significant challenges for the IRS as well as taxpayers. Approximately 62 percent of the failure to deposit penalties assessed under this system are later abated.[1] Erroneous assessments are a burden on taxpayers and a drain on IRS resources.

ANALYSIS OF PROBLEM

IRS Penalty Policy Statement P-1-18 states: "Penalties are an important tool in collecting the proper amount of tax revenue at the least cost. And in the interest of an effective tax administration, the IRS uses penalties to encourage voluntary compliance."[2] Taxpayers that do not follow the rules for depositing employment taxes are subject to a failure to deposit taxes (FTD) penalty.[3]

Currently, there are two schedules for depositing employment taxes: monthly and semi-weekly.[4] However, there are exceptions that affect taxpayers who accumulate $100,000 or more in employment tax withholding. If a taxpayer incurs a liability of $100,000 or more in withholding, the deposit must be made within one banking day.[5]

The IRS computes the penalty by multiplying the amount of under-deposited tax payments by the applicable penalty rate.[6] The rates are:

- Two percent if the deposit is one to five days late;
- Five percent if the deposit is six to 15 days late;
- Ten percent if the deposit is more than 15 days late; and
- Fifteen percent if the deposit is not paid within 10 days of the date of the notice of demand for payment.[7]

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[1] IRS Data Book 2002, Table 26, p. 33.

[2] IRS Penalty Policy Statement P-1-18 (August 1998).

[3] *See* 26 CFR 301.6656-1 for a complete explanation of Federal Tax Deposit Rules for withheld income taxes and taxes under Federal Insurance Contributions Act (FICA). The Penalty for Failure to Deposit Taxes is assessed under IRC § 6656.

[4] 26 CFR 31.6302-1.

[5] 26 CFR 31.6302-1(c)(3).

[6] IRC § 6656(a).

[7] The date of the notice of demand for payment is either the date on which a notice is issued under IRC § 6303 or the date on which the IRS issues an immediate demand for payment (in jeopardy cases).

In addition, taxpayers that deposit the correct amount but use the wrong method (not using the Electronic Filing Tax Payment System) are subject to a 10 percent penalty for avoiding the FTD system.

Under Internal Revenue Code section 6656, the IRS may impose a failure to deposit penalty if a taxpayer does not deposit the correct amount when due and in the appropriate manner, unless the taxpayer can show that failure is due to reasonable cause and not willful neglect. Reasonable cause means using ordinary business care and prudence; willful neglect is a conscious, intentional failure or reckless indifference.[8] Although penalty provisions in the Code are necessary to encourage taxpayers to file and pay taxes when due, some provisions can result in disparate treatment of taxpayers. Congress recognized this disparity and enacted legislation to change the penalty structure while keeping intact the framework of a voluntary compliance system.

Congress enacted the four-tiered FTD penalty structure in 1989 because the prior flat rate of 10 percent was considered too harsh and lawmakers wanted to give taxpayers an incentive to promptly resolve any failure to deposit taxes.[9] In 1996, Congress enacted the Taxpayer Bill of Rights 2, amending IRC§ 6656 by adding subsections (c), Exceptions for first time depositors, and (d) Authority to Abate Penalty where deposit is sent to Secretary.[10] The IRS Restructuring and Reform Act of 1998 (RRA 98) amended subsection (c) relating to exemption for first time depositors, and added subsection (e) to Section 6656, giving taxpayers the ability to designate payments.[11]

Today, when taxpayers receive penalty notices, they have 90 days from the date of the notices to contact the IRS and designate the application of tax payments to minimize the penalties. RRA 98 also provides for a deposit to be applied to the most recent period. To ease taxpayer burden and provide relief, the IRS also has authority to waive the failure to deposit penalty in certain circumstances: including for first time depositors or those whose deposit schedules or amounts have changed.[12]

In a typical year, many employers who consistently comply with the tax laws may nonetheless have FTD penalties assessed against them. After abatements, substantially fewer penalties are actually paid.[13] The IRS spends significant resources computing and assessing FTD penalties but expends an even greater volume of time and effort abating

[8] Treas. Reg. 301.6651-1(c)(1).

[9] H.R. Rep. No. 247, 101st Cong. 1st Sess. 1382 (Sept. 20, 1989).

[10] Pub. L. No. 104-168, § 304, (July 30, 1996).

[11] Pub. L. No. 105-206, § 3304, (July 22, 1998).

[12] 26 CFR 301.6656-1.

[13] Department of Treasury, Office of Tax Policy, *Report to Congress on Penalty and Interest Provisions of Internal Revenue Code*, October 1999, p. 222.

them.[14] In calendar year 2002, the IRS assessed $4.9 billion in FTD penalties and abated approximately $3 billion.[15]

Generally, IRS computers churn out FTD penalty notices automatically with little regard for extenuating circumstances for the failure to deposit.[16] The Department of the Treasury has stated that, "Dealing with penalty notices from the IRS is a time consuming and expensive process for employers, regardless of whether the notice is correct."[17] In 2002, the IRS generated almost two million notices advising taxpayers of FTD penalties, insufficient tax deposits, errors regarding FTD coupons, and the use of the wrong deposit method.[18] "Due in large part to its antique and limited computer system, the IRS's correspondence does not do a good job of explaining penalties and interest to taxpayers. Because they are issued in large batches, the letters are impersonal, written to suit many different situations, and the use of only capital letters makes them hard to read."[19]

While the IRS expends significant automated resources computing and assessing FTD penalties, it spends an even greater amount of human resources abating these same penalties. Taxpayers who are unable to resolve penalty issues with the IRS may turn to the Taxpayer Advocate Service (TAS) for help, and frequently do so because of operational delays.[20] In calendar year 2002, TAS received over 2,000 requests for assistance from taxpayers who were assessed the FTD penalty. Ninety-five percent of these requests involve small business taxpayers; the remaining five percent involve large and mid-sized businesses. A snapshot of the quarter of October 1, 2002 through December 31, 2002 shows TAS closed 525 FTD penalty cases in that time.[21] In 408 of these cases, relief was granted and the penalty was reduced and/or abated. On average, the cases were resolved in 70 days.

IRS data reveals that 85 percent of taxpayers assessed an FTD penalty in 2002 did not follow the deposit rules, including avoiding the Federal Tax Deposit System, and 15 percent

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[14] In October 2002, the Small Business/Self Employed Division Federal Tax Deposit Penalty Improvement Project Team found that the FTD penalty is assessed at the highest volume of all penalties, but is also the most frequently adjusted penalty assessment by IRS.

[15] Internal Revenue Service Data Book 2002, Table 26, p. 33.

[16] Department of Treasury, Office of Tax Policy, *Report to Congress on Penalty and Interest Provisions of Internal Revenue Code*, October 1999, p. 222.

[17] Id.

[18] IRS Office of the Notice Gatekeeper, Business Master File Cumulative Notice Volume for calendar year 2002. BMF notices include taxpayer inquiry (CP, annual notification of FTD requirements (CP 136), and Notification of impending FTD assessments (CP207), September 10, 2003.

[19] Joint Committee on Taxation, Study of Present Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring And Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)(JCS-3-99), Volume II, July 1999, p. 44.

[20] TAS Criteria Codes that indicate an operational delay are: Criteria 5 - Delay more than 30 days, Criteria 6 - No response by Date Promised, and Criteria 7 - Systemic or Procedure Failure.

[21] Taxpayer Advocate Service Business Performance Reviews (February 2003).

were assessed an FTD penalty under an averaging method.[22] The IRS uses the averaging method when taxpayers do not properly complete and/or file a Schedule B, Form 941, and Record of Federal Tax Liability (ROFT).[23] In calendar year 2002, the IRS issued approximately 150,000 notices advising taxpayers that their Schedule Bs were missing, incomplete, or illegible.[24] This is a decrease of nearly 35,000 notices from the prior year. However, the Form 941 Schedule B (ROFT) remains a problem for some taxpayers to complete.

Additional IRS data reveals that monthly depositors were assessed more FTD penalties than semi-weekly ones.[25] Errors occur when taxpayers do not change the frequency of deposits as their tax liabilities increase. The IRS notifies these taxpayers about the mistakes, but they may not receive the notices for weeks.

The analysis of this issue identifies a significant problem in the administration of the FTD penalty. A substantial number of penalties assessed under IRC § 6656 are abated. Current IRS practices result in both the IRS and taxpayers expending valuable time and resources in negotiating requests for abatement of the FTD penalty. Further, taxpayer confusion about federal tax reporting can lead to penalties.

IRS COMMENTS

Over the past several years, the Internal Revenue Service has continued to refine and enhance the Federal Tax Deposit (FTD) penalty program. Notices related to IRC § 6656 (Penalty Assessments for Late Deposits) now include penalty calculations and are written in simpler language for the public. Internal Revenue Service Notice 931 (Deposit Requirements for Employee Taxes) and its related documents, mailed with CP 136 and CP 137 Notices (Annual Notification of FTD requirements 941/943), provide taxpayers with easy to understand information regarding requirements for the depositing of their federal taxes. Tax forms and publications are also updated annually to provide business taxpayers with easier to understand and use documents. A major revision to the Form 941 and its Record of Federal Tax Liability (ROFT) Schedule will be in place for 2005 tax periods, which should simplify filing.

[22] IRS One Percent Penalty File 200212, Extract of Failure to Deposit Penalty (Business Operating Division and Penalty Computation Code, August 27, 2003. This data file contains approximately one percent of all the tax accounts in the IRS Business Master File. Data was extracted from calendar year 2002 for Form 941 quarterly return.

[23] When taxpayers file Form 941, they may be required to file a Schedule B (Form 941) Employer's Record of Federal Tax Liability (ROFT). The IRS uses the return information and the ROFT schedule to determine if the taxpayer has deposited the correct amount of taxes on time and in the right manner. The IRS matches the tax liability information listed on the ROFT to the payment information from the taxpayers' deposits. If the ROFT is incorrect, incomplete or missing, the IRS computes the FTD penalty based on an average of the tax liability.

[24] IRS Cumulative FTD Notice Volumes for calendar year 2002.

[25] IRS One Percent Penalty File 200212, Extract of Failure to Deposit Penalty (Base Period Indicator Form 941 - 2002) August 22, 2003.

Based on a recent analysis of data from the 2002 Data Book, the 62 percent abatement rate discussed by the Advocate refers to the total penalty dollars abated. This is not a true indicator of the success or failure of the program since the dollar amount of a large penalty of even one taxpayer can significantly impact the total dollars assessed. We believe a more accurate reflection of program accomplishment is the number of entities that are abated. Our analysis indicates that in 2002, 24 percent of the taxpayers, with FTD penalties assessed, received abatement; 76 percent of assessed FTD penalties were sustained.

There are several reasons why FTD penalties are assessed, including incorrect return/tax liability information submitted by the taxpayer or late tax deposits. The fact that an FTD penalty is reduced or abated does not mean it was an erroneous assessment. Depending on the reason for the penalty, it may be abated if the taxpayer either provides the missing information or submits a written request for penalty relief due to reasonable cause.

IRS INITIATIVES TO RESOLVE PROBLEM

We have taken steps to improve the FTD program and reduce burden on taxpayers. When a taxpayer is subject to an FTD penalty, the IRS now runs the taxpayer's deposit information through two penalty computations to identify and assess the lowest penalty assessment based on the most recent deposit information. Also, the IRS has implemented a waiver of the FTD penalty for the first tax period following a taxpayer's change in deposit requirements. This has resulted in a drop in the overall number of FTD penalties assessed.

Beginning January 2004, the IRS will issue CP236 (Reminder to deposit semi-weekly), as an early intervention notice. This notice will advise newly required semi-weekly depositors that it appears they may still be depositing under the incorrect monthly requirements. This early intervention will provide those taxpayers time to correct their depositing error before the beginning of the next tax quarter, thereby avoiding a penalty.

The IRS also continues to promote the use of the Electronic Federal Tax Payment System (EFTPS) instead of FTD Coupons-Form 8109. Use of EFTPS will reduce the burden on taxpayers by eliminating the need for them to respond to notices regarding incomplete paper coupons and misapplied payments, which often result in penalty assessments. The IRS is planning a project that will offer a one-time FTD penalty refund for coupon depositors (taxpayers not currently enrolled in EFTPS) if they use EFTPS to make timely tax deposits for four consecutive quarters. The national rollout of this project will benefit taxpayers penalized in 2004. Those taxpayers will receive an FTD penalty abatement of the last paid FTD penalty, with the credit used to pay the penalty becoming a refundable credit. This effort, as well as other initiatives, is continuing to make the FTD penalty program more effective.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate supports the IRS' efforts to improve the Federal Tax Deposit System. Failure to Deposit problems have made been included on the list of the Most Serious Problems Facing Taxpayers in the Annual Report to Congress for the past eight years, and each year the IRS has responded with a list of initiatives and actions taken to address the problem.

The National Taxpayer Advocate acknowledges that in fiscal year 2002, the IRS abated 62 percent of the total FTD penalty dollars assessed. We further agree that 24 percent of the penalties assessed were abated and 76 percent were sustained. The IRS stated that the 62 percent is not a true indicator of the success or failure of the FTD penalty program. However, our analysis suggests that it is not just the number of penalties assessed that paints an accurate picture of the failure or success of the FTD penalty program. Other factors include the number of taxpayers and tax periods involved. A taxpayer can be assessed more than one penalty within a given tax year. When the data is stratified according to the IRS business operating divisions, some patterns become obvious.[26]

TABLE 1.17.1, ANALYSIS OF FTD PENALTY BY BUSINESS OPERATING DIVISION FISCAL YEAR 2002 (IRC 6656):[27]

BOD	Number of Penalty Assessments	Number of Penalty Abatements	%	Penalty Assessments ($)	Penalty Abatements ($)	%
LMSB	61,687	24,175	40	1,708,538,410	1,401,803,477	82
SB/SE	2,170,181	399,444	18	2,364,903,798	749,787,673	31
TE/GE	112,249	37,920	34	747,788,991	598,135,868	80
W&I	6	0	0	18,223	0	0
Total	2,344,123	461,539		4,821,187,735	2,749,727,018	

The data shows that the higher the dollar amount of the penalty, the higher the probability that the penalty will be abated. This is especially true for large and midsize businesses. Forty percent of the number of FTD penalties assessed against large businesses are abated. One example clearly illustrates the cost to the IRS.

EXAMPLE:

A corporate taxpayer files Form 941 for the tax period ending December 31, 2002.[28] The total tax liability listed on the return is more than $1 billion dollars and the taxpayer's total federal tax deposits exceed the liability by

[26] This data is not from the IRS data book but from a report prepared by the IRS Office of Revenue Analysis, Enforcement Revenue Information System Report: ALL BOD FTD Penalty Data Feb-2003.

[27] IRC § 6721. Data on Intentional Disregard Penalty from IRS Office of Enforcement Revenue Information System (ERIS), May 2003. ERIS captures data on civil monetary penalties.

> $1.8 million.[29] The IRS assesses a penalty of $25 million against the taxpayer, using the averaging method, because the return was allegedly filed without an accompanying Schedule B, Employer's Record of Federal Tax Liability. It takes the IRS approximately four months to resolve the penalty, and the taxpayer's account shows activity by more than three IRS campuses. In the end, the IRS abates the FTD penalty in full and refunds $1.8 million (the overpayment) plus $30,461 in interest to the taxpayer.

A closer examination of this particular example reveals that the IRS could have taken proactive steps to prevent the problem. The taxpayer's parent corporation is a very large and complex corporation with a number of subsidiaries and related entities. The parent corporation's account is assigned to a specialized unit on an IRS campus - the Large Case Technical Unit (LCTU), which provides large corporate taxpayers with dedicated service from a Tax Examiner for all account related issues. The tax examiner performs a full range of account management work, is proactive in detecting and correcting account problems, and also reviews notices before they are mailed to the taxpayer.[30] In addition to the dedicated service from LCTU, in this instance there was an IRS audit team at the taxpayer's corporate headquarters conducting an audit. The Failure to Deposit penalty problem in this instance could have been avoided.

The position of the IRS is that the dollar amount of a large penalty of even one taxpayer can significantly impact the total dollars assessed. The Taxpayer Advocate Service agrees with the statement and encourages the IRS to focus on refining and enhancing the program to address large dollar FTD penalty notices.

The National Taxpayer Advocate also supports IRS efforts to promote the use of the Electronic Federal Tax Deposit System among small business taxpayers over FTD paper coupons - Form 8109. The SB/SE division's business plan for fiscal year 2003 is to make e-filing & EFTPS the preferred options for small business taxpayers by maximizing electronic services available. We support this goal, especially since it will reduce a number of errors commonly made on the coupons. However, we reserve further comments about the upcoming national rollout of a plan to offer a one-time FTD penalty refund for coupon depositors (taxpayers not currently enrolled in EFTPS). We are curious about the test results from the pilot. The Taxpayer Advocate Service will closely monitor the national rollout, scheduled for January 2004, to ensure that taxpayers fully understand the commitment they are making and that the Internal Revenue Service's goals and objectives are clearly communicated to taxpayers.

[28] The tax return was filed by a subsidiary of the large corporate taxpayer that handles the corporation's payroll.

[29] Id.

[30] Internal Revenue Manual Sections 21.7.1.4.10.5 and 21.7.1.4.10.6.

RECOMMENDATIONS

Administrative

In 1996, the Taxpayer Advocate first identified the difficulty of understanding Federal Tax Deposit requirements as one of the most serious problems encountered by taxpayers. The IRS then commented that it was conducting a comprehensive analysis to determine the effectiveness of the deposit regulations changes made in 1993, and to identify compliance problems.[31] *The IRS completed a comprehensive study and issued a lengthy report entitled: Federal Tax Deposit Study.*[32] *The report was not released outside of the IRS, but did conclude that "the responsibility of producing a smooth running FTD system falls not only on employers, but also the Service and third parties (i.e. banks)."*[33]

The study noted above should be updated to reflect the changes brought about by the IRS Restructuring and Reform Act of 1998 and the improvements the IRS has implemented since then including technology and industry changes in banking and payroll sector. An updated study could be used as a road map in understanding the myriad of problems that are plaguing the federal tax deposit system.

The National Taxpayer Advocate encourages the IRS to pursue sustainable solutions rather than quick fixes and gimmicks to influence taxpayer compliance. The IRS should assemble a team or group to do a comprehensive analysis of the system, identify the problems, and recommend measurable solutions.

Currently, the Taxpayer Advocate Service's Office of Systemic Advocacy is working on an advocacy project with the Large and Midsize Business Division to address employment tax problems that large corporate taxpayers face, including large dollar FTD penalties. In addition, a number of systemic advocacy analysts are members of service-wide taskforces that are looking into filing problems involving Form 941 and Schedule B problems and redesign of employment tax forms. The National Taxpayer Advocate is aware of a number of IRS working groups and taskforces that are focusing on various aspects of FTD system and urges the IRS to pull these groups under one umbrella group. Once group working on this problem encourages sharing of information and data and will minimize duplication and competing initiatives.

[31] Taxpayer Advocate, *Annual Report to Congress,* January 16, 1997.

[32] Internal Revenue Service, Statistics of Income Division and the Office of Penalty Administration, Federal Tax Deposit Study.

[33] Federal Tax Deposit Study, IRS Statistics of Income Division and Office of Penalty Administration, July 1997.

Legislative

In 2001, the National Taxpayer Advocate proposed a legislative recommendation to reduce the 10 percent penalty rate for failure to make a deposit in the manner prescribed to a two percent penalty rate.[34] *"Perceptions within and outside of the Internal Revenue Service are that the 10 percent penalty rate is harsh and disproportionate to the nature of the error committed."*[35] *The following bills have been introduced to decrease the penalty from 10 percent to 2 percent: H.R. 1528, Taxpayer Protection and IRS Accountability Act of 2003, and H.R. 1661, Taxpayer and Fairness Protection Act of 2003.*

34 The National Taxpayer Advocate first proposed this legislative recommendation in 2001 and since then has continued to support legislation introduced by Congress. *See* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Revision 12-2001), p. 222.

35 Assisting Small Business Through the Tax Code, Recent Gains and What Remains to be Done, Hearing Before the House Committee on Small Business, 108th Cong., 1st Sess, July 23, 2003 (Statement of Nina E. Olson, National Taxpayer Advocate).

RESPONSIBLE OFFICIALS

Henry O. Lamar, Commissioner, Wage and Investment Division
Dale Hart, Commissioner, Small Business/Self-Employed Division

DEFINITION OF THE PROBLEM

Low income Social Security recipients with delinquent income tax debts are subjected to levies that cause hardship and undue taxpayer burden. The IRS uses a filtering process to prevent levies from being placed on taxpayers with incomes below an established threshold, but the system is frequently inaccurate. The IRS has no reliable, systemic method of predicting hardship.

ANALYSIS OF PROBLEM

The Taxpayer Relief Act of 1997 (TRA 97) established the Federal Payment Levy Program (FPLP),[1] which began in July 2000, to ease the administrative burdens of collecting taxes by levy.[2] The Act also authorizes the IRS to continuously levy up to 15 percent of certain specified payments that were previously exempt from levy. Specified payments include any federal payments other than those for which eligibility is based on the income and/or assets of the recipients, unemployment benefits, worker's compensation, wages or salaries, and certain public assistance payments.[3] These payments (including Social Security Administration (SSA) benefits) are considered wage replacement benefits.[4] The legislation authorizes the IRS to treat wage replacement income the same as wage income.[5] Levies on wage replacement income are not subject to the exemptions established by Internal Revenue Code (IRC) section 6334.[6]

The FPLP utilizes federal computer systems to collect the levy payments. To identify taxpayer accounts for this program, the IRS sends a file of delinquent accounts to the Department of the Treasury's Financial Management Service (FMS), which processes payments for various federal agencies. The IRS records are matched against FMS records to locate recipients of federal payments who have delinquent income tax debts.

When a match is found, the IRS notifies the recipient of the potential levy. This notification contains information about the delinquent tax debt and the taxpayer's appeal rights. The taxpayer has 30 days to respond before the IRS electronically transmits the levy to FMS. For a SSA levy, the IRS sends an additional notice (if the taxpayer does not

[1] IRC § 6331(h).

[2] Revenue Reconciliation Act of 1997, H.R. Rep. 105-148, Title X, Subtitle D, §§ 1034, 1035, & 1036.

[3] IRC § 6331(h)(2).

[4] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, August 5, 1997, § 1024.

[5] Revenue Reconciliation Act of 1997, H.R. Rep. 105-148, Title X, Subtitle D, §§ 1034, 1035, & 1036.

[6] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, August 5, 1997, § 1024.

respond to the first notice) before transmitting the levy to FMS.[7] When each payment is levied, FMS sends a notice to the taxpayer's address of record with the Social Security Administration (or the applicable paying agency for non-SSA payments).

Although other types of federal payments are included in the Federal Payment Levy Program,[8] over 90 percent of the FPLP levies issued in fiscal year 2003 were SSA levies.[9] Of the total levies collected under FPLP in the last two fiscal years, nearly 80 percent were from SSA recipients.[10]

TABLE 1.18.1, FPLP LEVY STATISTICS[11]

Levies	FY 2002	FY 2003
Total Levies Issued[12]	382,887	521,390
SSA Levies Issued	331,946	477,434
Total Amount Collected	$60,241,322	$74,398,402
SSA Amount Collected	$42,820,159	$62,470,257

Before the levy program was implemented, the National Taxpayer Advocate worked with the IRS to ensure that targeted communication and outreach strategies were developed. In October 2001, IRS sent notices to approximately 232,000 Social Security recipients who owed federal debts, advising them that levies would begin in February 2002. The IRS issued nationwide news releases about the levies, while the Taxpayer Advocate Service coordinated outreach activity to key local organizations.[13]

The National Taxpayer Advocate also helped the Small Business/Self-Employed Operating Division (SB/SE) establish an exclusion for low-income SSA recipients for whom levies might create financial hardships. The exclusion is based on the Total Positive Income (TPI) amount reported on the taxpayer's last filed federal tax return.[14]

[7] Internal Revenue Manual (IRM) 5.19.9.3.2.5, and IRM Exhibit 5.19.9-6, CP91, Final Notice Before Levy on Social Security Benefits. If the taxpayer is eligible for and has not yet received his or her notice of a collection due process hearing, the IRS will also send such notice under IRC § 6320 or § 6330.

[8] IRS Publication 594, The IRS Collection Process, (Rev. 1-2003), p. 9. Under the Federal Payment Levy Program, the following federal payments are subject to levy: retirement from the Office of Personnel Management, social security benefits, federal vendor payments, federal employee salaries, or federal employee travel advances and reimbursements.

[9] FPLP Fiscal Year 2003 Payment Type Report, IRS Wage & Investment Compliance Policy, Filing and Payment Compliance Office, Cumulative Through 7/31/2003.

[10] FPLP Fiscal Years 2002 and 2003 Payment Type Reports.

[11] Id.

[12] The categories of Total Levies Issued and SSA Levies Issued do not reflect the number of taxpayers levied. They represent the number of payments levied each month. One taxpayer can be levied up to 12 times in the fiscal year for each type of federal payment received.

[13] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), p. 241.

[14] IRM Exhibit 4.1.7-1(33). Total Positive Income (TPI). Only total positive values from the income fields are used. Losses are treated as zero. (a) Wages, (b) Interest, (c) Dividends, (d) Other Income 1.State Tax Refund, 2. Alimony, 3. Schedule D Profits, 4. Capital Gains Distributions, 5. Form 4797, 6. Fully Taxable Pension, 7. Rents and Royalties, 8. Income Other, (e) Distributions 1. Partnership, 2. Small Business Corporations, 3. Estate or Trust, (f) Schedule C Net Profits, (g) Schedule F Net Profits.

The IRS instituted a filter to systemically remove from the levy program certain SSA recipients with TPI amounts below the established threshold. Unfortunately, the IRS implemented the notice process before it completed the computer programming necessary to incorporate the exclusion. Thus, some taxpayers who received notices of intent to levy would not have received them had the exclusion been in effect.

Most FPLP notices included a Collection Due Process (CDP) notice, describing the procedure for appealing the proposed levy at a CDP hearing.[15] In response, approximately 1,100 taxpayers requested hearings; of these, more than 50 percent would not have received the notice had the exclusion programming been in place.[16] The Taxpayer Advocate Service (TAS) selected a statistically valid sample of 222 taxpayers from the group who would not have received the notice, and monitored their accounts to proactively address any concerns resulting from this notice issuance.[17]

As of March 20, 2003, when the study concluded, 73 percent of the cases were closed. Of the entire sample,

- Twenty-seven percent were determined uncollectible due to hardship. (An additional five percent were deemed uncollectible for other reasons.)[18]
- Twenty-five percent were resolved because the tax was fully paid, paid through installments or offers-in-compromise, or the statutory period for collecting the tax expired.[19]
- Nineteen percent were referred back to Collection employees.[20]

From the inception of SSA levies, both the National Taxpayer Advocate and SB/SE acknowledged that the TPI screen was imperfect at best. Some taxpayers who reported

[15] IRC § 6330. The Collection Due Process notice, Letter 1058, *Final Notice, Notice of Intent to Levy And Notice Of Your Right To A Hearing,* includes Publication 594, *What You Should Know About The IRS Collection Process;* Publication 1660, *Collection Appeal Rights*; and Form 12153, Request for a Collection Due Process Hearing.

[16] CDP Hearing Requests on CP90s - FPLP SSA recipients, IRS Wage & Investment Division CDP Operations Report, list compiled February 7, 2002.

[17] Of the 1,100 taxpayers requesting a CDP hearing, 577 would not have received a notice if the programming had been implemented for the exclusion. TAS monitored the accounts for 222 of the 577 taxpayers who met the criteria for exclusion.

[18] The percentage of uncollectible cases was based on the “unable to pay” IRS Collection closing code on the tax accounts as listed in IRS Document 6209 (Rev. 3-2002), pp.11-42.

[19] Taxpayer Advocate Service, Systemic Advocacy FPLP SSA CDP Study (Rev. 7/7/2003). Of the 55 resolved cases: 9 were adjusted to zero balance, 3 were partially adjusted and the balance was paid, 14 were paid in full, 15 were paid by installments, 8 were resolved through the Offer-in-Compromise program, and the statute expired on 6 cases.

[20] Id. Of the case sample (222): 163 cases were closed and 5 cases were in process to be closed. Of these, 60 cases were determined uncollectible due to hardship, 11 cases were determined uncollectible for other reasons, 55 cases were resolved, and 42 cases were referred back to Collection employees.

high incomes on their last returns may now have lower incomes and do not need to file returns. Other taxpayers may show relatively little income on their last filed returns, yet have substantial assets and the ability to pay the tax.

The General Accounting Office (GAO) concluded in a March 2003 study that the TPI exclusion is "an inaccurate indicator of a taxpayer's ability to pay."[21] The IRS Small Business/Self-Employed Operating Division conducted its own analysis of FPLP and issued a memorandum that states: "Using the TPI on the LRF (Last Return Filed) as an indicator of the taxpayer's ability to pay has several inherent flaws."[22]

The IRS has no means of predicting hardship status. Although the agency maintains numerous systems with taxpayer data (for example, tax return information, and sources of income information from employers, or banks), these systems do not interface. This lack of communication between computer systems makes it impossible to combine systemic data and predict hardship with any degree of certainty. Until a better system is in place to filter out those for whom this levy authority will cause a hardship, IRS will continue to risk creating hardship situations for a vulnerable segment of the population.

Social Security recipients rely heavily on Social Security as their primary source of income. Social Security provides at least half of total income for a majority of beneficiaries.[23]

- Social Security pays benefits to 91 percent of those aged 65 or older. It is the major source of income (50 percent or more of total income) for 65 percent of the beneficiaries, contributes 90 percent or more of income for one-third of them, and is the only source of income for 20 percent of them.[24]
- In calendar year 2001, Social Security recipients received an average monthly benefit of $874.[25]
- Fifty-one percent of married couples with a member of the household age 65 and over had incomes of less than $35,000 annually.[26]
- The poverty rate for people age 65 and over is 10.1 percent.[27]

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[21] General Accounting Office, *Tax Administration, Federal Payment Levy Program Measures, Performance and Equity Can Be Improved*, GAO 03-356, March 6, 2003, p. 11.

[22] SBSE, Memorandum for Jeffrey J. Basalla, Director Filing and Payment Compliance, *Making More Debts Available for Federal Payment Levy Program (FPLP) Levy*, August 26, 2002, pp. II-2 & II-3.

[23] Social Security Administration Office of Policy, Office of Research, Evaluation, and Statistics, Income of the Aged Chartbook, 2001, April 2003.

[24] Id.

[25] U.S. Census Bureau, *Statistical Abstract of the United States: 2002, Section 11, Social Insurance and Human Services,* No. 519. Social Security (OASDI) - Benefits by Type of Beneficiary: 1980 to 2001, p. 346.

[26] U.S. Census Bureau, *Facts for Features: Older Americans Month Celebrated in May*, available at http://www.census.gov/Press-Release/www/2003.

[27] Id.

- Eighteen percent of men and 10 percent of women age 65 and over are still in the civilian labor force.[28]

Any reduction of Social Security income has the potential to cause hardship to a majority of Social Security recipients. This fact alone justifies the use of an income exclusion in the FPLP. Further, 6.7 million Social Security recipients have their payments sent to alternate payees such as nursing homes or guardians.[29] To date, the Service has not been able to obtain data from the Social Security Administration that would enable it to screen for alternate payees. Levying on these payments, which are sent to caregivers, can jeopardize the care of elderly and/or disabled persons. Since levy notices are sent to the Social Security address of record, the IRS may also be unintentionally disclosing taxpayer information to people who are not authorized to have it.

The Federal Payment Levy Program continues to cause hardships for some taxpayers despite IRS efforts to remove low income and other at-risk taxpayers from the program.

IRS COMMENTS

As of June 2003, there were over $4.5 billion in unresolved federal tax debts owed by taxpayers who receive Social Security benefits.[30] Currently, out of 46 million taxpayers receiving benefits,[31] the FPLP has an outstanding levy on one-tenth of one percent, or approximately 45,000 of those taxpayers.

The IRS initially issued approximately 200,000 notices to taxpayers that matched with a Social Security payment prior to incorporating the income exclusion programming. The GAO, in its March 2003 study, concluded that no more than 10 percent of those taxpayers were resolved under a financial hardship determination regardless if they were above or below the exclusion criterion.[32] GAO also expressed concern that use of the current income exclusion results in potential inequitable treatment of taxpayers with similar ability to pay.

[28] U.S. Census Bureau, *Facts for Features: Older Americans Month Celebrated in May*, available at http://www.census.gov/Press-Release/www/2003.

[29] Ensuring the Integrity of Social Security Programs: Protecting Seniors from Representative Payee Fraud, Hearing of the Senate Special Committee on Aging, 108th Congress, 1st Sess, September 9, 2003, p.1 (Testimony of Fred Streckewald, Assistant Deputy Commissioner, Disability and Income Programs).

[30] Source: IRS Information Systems Unpaid Assessments Unit (Accounts Receivable Dollar Inventory), Report on FPLP Social Security matches.

[31] Approximate number of beneficiaries in the Old-Age, Survivors and Disability Insurance (OASDI) program. Source: http://www.ssa.gov.

[32] General Accounting Office, *Federal Payment Levy Program Measures, Performance and Equity Can Be Improved*, GAO 03-356, March 2003, p. 13. The GAO report found that the hardship rate of those who received and responded to a Final Notice yet were below the TPI exclusion threshold (to be excluded from actual levy) was 5 percent, and those who were above the threshold (to be levied) was 8 percent. The overall hardship rate on those above the TPI exclusion threshold and responded to either the notice or levy was 10 percent.

We are committed to ensuring all taxpayers are treated fairly and are concerned about all potential hardship cases. As the Taxpayer Advocate points out, we do not currently have a reliable systemic way to predict hardship. The IRS levies only on delinquent accounts that are not resolved, for example, through financial hardship determinations, offers-in-compromise, full payment, installment agreement, bankruptcy or litigation claims or other legal or administrative situations. Prior to issuance of a levy, each taxpayer receives a series of collection notices requesting payment and providing a toll-free number that may be used to contact us in order to discuss other options to resolve their account. We also send by certified mail a Collection Due Process (CDP) notice describing the procedures for appealing the proposed levy at a CDP hearing. Taxpayers are given 30 days to respond. Social Security beneficiaries subject to levy are sent a special second notice giving an additional 30 days to contact us in order to resolve their account. We rely on taxpayers contacting us in response to notices if they are unable to full pay their account. Once contacted, if the taxpayer indicates a hardship condition, we will secure the necessary financial information to make a hardship determination.

We agree with the Taxpayer Advocate that the current income exclusion criterion is flawed. In response to the GAO report, we have established a cross-functional task group that includes representatives from the Taxpayer Advocate's office and our Information Technology Division, to explore potential systemic alternatives to the current exclusion criterion that would reliably identify Social Security beneficiaries for whom a levy would represent an undue hardship.

We would like to clarify the issue raised regarding unintentional disclosure resulting from the levy notices being sent to the Social Security address of record in cases where Social Security recipients have designated alternate payees. The Financial Management Service (FMS), as the disbursing agent for the benefits, issues the levy notice to the taxpayer in order to advise them why their benefit was reduced. FMS uses the Social Security address on those cases where the taxpayer is receiving a paper check from Social Security. If the taxpayer receives their benefit through an electronic deposit, then FMS uses the IRS address on the levy notice. For paper check recipients, mailing the IRS notice of levy to the taxpayer's Social Security address of record is the most reliable method of notifying the taxpayer. Where the taxpayer provides Social Security the address of a third party as his/her address of record, use of that address by FMS to mail the IRS notice of levy does not constitute an unauthorized disclosure under IRC § 6103.

TAXPAYER ADVOCATE SERVICE COMMENTS

We support the IRS in its efforts to find alternatives to the TPI exclusion, as well as its improvements to the procedures and programming throughout the process. While we agree that the number of Social Security recipients actually levied is a small percentage of the total population of recipients, this is a particularly vulnerable segment of taxpayers. Therefore, the National Taxpayer Advocate and IRS are continuing to develop improvements to the exclusion process, with the ultimate goal of creating a systemic exclusion that more accurately identifies SSA recipients most likely to experience a hardship if levied upon.

The National Taxpayer Advocate is concerned that the substitution of the SSA's alternate payer address for that of the taxpayer's could (1) be an inadvertent disclosure under IRC § 6103 and (2) result in harm to the taxpayer. Consider the following situation: Taxpayer is incapacitated and cannot attend to her affairs. Her niece has been appointed guardian and conservator by the local court. Taxpayer's niece is designated as the alternate payee. Taxpayer's Social Security payment is sent to the corporate office of the nursing home, which is in an adjacent state. The corporate office's address is the address of record of the alternate payee for Social Security purposes. Under this scenario, it is unlikely that the nursing home corporate office would be a person of material interest. It is also unlikely that an IRS notice sent to a corporate office will be forwarded (if at all) to the taxpayer or her guardian in time for her to resolve the issue proactively.

The National Taxpayer Advocate has elevated this issue to the Office of Chief Counsel. She will work with that office and Wage and Investment to address her concerns and improve administration of this program.

RECOMMENDATIONS

- *Since the inception of the Federal Payment Levy Program on Social Security Benefits, the Taxpayer Advocate Service has developed Publication 4134, Free/Nominal Cost Assistance Availability for Low Income Taxpayers. The National Taxpayer Advocate recommends that the IRS include this stuffer notice in its first and second mailings to SSA taxpayers in the Federal Payment Levy Program.*
- *Taxpayer Advocate Service marketing research shows that surviving spouses are particularly likely to experience tax problems.[33] The National Taxpayer Advocate recommends that IRS Stakeholder Partnerships, Education and Communication (SPEC) develop and implement a continuing communication and outreach strategy to inform this taxpayer segment of its rights, responsibilities, and avenues for assistance (including TAS and Low Income Taxpayer Clinics) in tax matters. Those strategies will supplement any filters the task force may devise.*

[33] Russell Marketing Research, *Findings from a Qualitative Study of the TAS Underserved Segments 34-38,* April 2002.

PROBLEM TOPIC #19 MOST SERIOUS PROBLEM: MANUAL REFUND INCONSISTENCIES

RESPONSIBLE OFFICIALS

Henry O. Lamar, Commissioner, Wage and Investment Division
Dale Hart, Commissioner, Small Business/Self-Employed Division

DESCRIPTION OF PROBLEM

The ten IRS campuses (formerly called service centers) have varying procedures for issuing manual refunds, as well as different standards for the documentation that taxpayers must provide to obtain them. These variances have caused inconsistent treatment of taxpayers and delays in processing Taxpayer Advocate Service (TAS) cases involving manual refunds.

ANALYSIS OF PROBLEM

What is a Manual Refund?

The IRS is required to issue a refund when a taxpayer's account is overpaid, after any offsets have been processed.[1] Under normal procedures, the IRS issues the refund within three weeks.[2] A "manual refund" is one that is not generated by normal computer processing. IRS employees use Form 3753, Manual Refund Posting Voucher, and Form 5792, Request for IDRS Generated Refund, to request manual refunds through the Accounting Function of the Submission Processing area at each campus.[3] The IRS most frequently issues manual refunds because:

- The refund is being paid to someone other than the name on the IRS master file;
- A hardship situation necessitates a quicker refund than normal systemic processing can provide;
- The refund is not for an IRS master file account (i.e. refund of photocopy fees); or
- Systemic limitations prevent a normal computer generated refund.[4]

The IRS can issue a refund in numerous circumstances, including relief of hardship (Taxpayer Advocate case); refunds on Form 4466, Corporation Application for Quick Refund Overpayment; Congressional inquiries; offers-in-compromise; taxpayers in bankruptcy; and deceased taxpayer accounts.[5] Taxpayers requesting manual refunds for hardship reasons should be referred to the Taxpayer Advocate Service (TAS) by thoroughly documenting Form 911, Application for Taxpayer Assistance Order.[6]

[1] Internal Revenue Manual (IRM) 21.4.6.2, What is a Refund Offset? Internal Revenue Code (IRC) §§ 6402(a), (c), and (d) require a taxpayer's overpayment to be applied to any outstanding federal tax, non-tax child support, federal agency debt, or state income tax obligation prior to crediting the overpayment to a future tax or making a refund. This application of a tax overpayment is called a refund offset.

[2] IRM 3.42.1.5, Refund Options. Taxpayer refunds can be expected to be issued within three weeks if the return is error free, has posted to the Master File, and the refund is not reduced by outstanding liabilities.

[3] IRM 21.4.4.1, What is a Manual Refund? (Rev. 10/01/2003).

[4] IRM 21.4.4.2, Why Would A Manual Refund Be Needed? (Rev. 10/01/2003).

[5] Id.

[6] Id.

An employee must consider differing manual refund options and choose the one that best meets the needs of the taxpayer and the IRS: for example, an IRS employee uses Form 5792 to request an Integrated Data Retrieval System (IDRS) manual refund.[7] The employee inputs the refund amount on IDRS and forwards the Form 5792 to Accounting for approval, and the taxpayer receives a paper refund check in seven to 10 days. The employee monitors the taxpayer's account for one to two weeks to confirm that the refund was issued and debited on the taxpayer's account.[8]

An employee prepares Form 3753 to request that the Manual Refund Function in Accounting issue a manual refund. The form must be used when a refund is $1 million or more, a direct deposit refund is necessary, or a manual refund is needed for an account not shown on the IDRS. If Form 3753 is used in a hardship situation, Form 911 will have been completed, and the TAS employee can request a direct deposit refund to the taxpayer's bank account within 48 hours. A taxpayer not facing hardship receives a paper refund check from an approved Form 3753 within three to five days. The IRS monitors the taxpayer's account for four to six weeks to verify that it was properly debited.[9]

When a taxpayer's circumstances are so dire that even the manual refund process will not provide help soon enough, the TAS can request an "Extreme Emergency Refund Check" within three days, or an "Extreme Emergency Electronic Funds Transfer" into a bank account within 48 hours. Natural disasters and life threatening circumstances are two situations that meet the criteria for an extreme emergency refund.[10]

The manual refund process is intended to expeditiously deliver a taxpayer's refund when the time needed to process a regular refund would create hardship. Therefore, delays in processing manual refunds compound the taxpayer's original hardship.

Campus Procedures Consistency Project Study

The objective of the Taxpayer Advocate Service's Campus Procedures Consistency Project is to identify procedures that cause undue delay or burden for taxpayers as a result of inconsistent approaches among the various IRS campuses[11] The TAS project established that many procedures vary between campuses, including those for processing manual refunds.

[7] The Integrated Data Retrieval System (IDRS) enables IRS employees to have instantaneous visual access to taxpayer accounts currently active on the system. Some capabilities using IDRS include researching account information, requesting tax returns, and entering changes to accounts.

[8] IRM 21.4.4.4.1.3.1, Manual Refund Timeframes (Rev. 10/01/2002).

[9] Id.

[10] IRM 21.4.4.4.4.1, Procedures Used for Extreme Emergency Refunds and Hardship Request Form 911 (Rev. 10/01/2002).

[11] National Taxpayer Advocate, *Fiscal Year 2004 Objectives*, Publication 4054 (Rev. 06-2003), p. 40.

One major difference affecting manual refunds is the validation of hardship. Some campuses require hardship documentation (such as a copy of an eviction/utility notice or mortgage foreclosure) for all types of manual refunds while one campus requires no proof of hardship at all. Some campuses require documentation for both paper and electronic Emergency Refunds; others for Electronic Fund Transfers only. Other variants for proof of hardship include an attached, signed statement from the Local Taxpayer Advocate (LTA) attesting to the hardship, taxpayer validation of the hardship, and worksheets and Forms W-2 when the refund request involves a Joint and Several Liability (Innocent Spouse) claim.[12]

Another disparity in manual refund processing involves the documentation required for large direct deposit refunds.[13] One campus requires Form 8302, Direct Deposit of $1 Million or More, to ascertain the bank routing transit number (RTN), and the taxpayer account number and type (checking or savings). At another campus, a voided check or deposit slip, or a bank letter verifying the routing and account numbers, must accompany the Form 8302. The remaining eight campuses do not require Form 8302 to accompany RTN and taxpayer account number documentation for refunds of over $1 million. Two campuses do not accept a deposit slip as proof of the RTN and taxpayer account number; these campuses report that some deposit slips contain in-house information that tends to be different from checking account numbers.

Different modes of delivery for manual refund documents also create delays and uneven treatment of taxpayers. For example, nine of the 10 campuses accept faxed copies of Form 3753, Manual Refund Posting Voucher and accompanying documentation, followed by same-day express mailing of the original documents. However, one site will not accept faxed copies to begin the manual refund process. This campus Accounting area instructs TAS employees requesting manual refunds for taxpayers to submit Forms 3753 by express mail, and does not process the request until it receives the original documents. However, because of the enhanced mail security measures implemented after the September 11th and anthrax attacks, it may take up to a week before the campus receives and processes the form and attachments, even when sent by express mail. This requirement defeats the purpose of the emergency refund procedures outlined in the IRM, because the manual states that taxpayers who would suffer a significant hardship will have emergency refunds processed in less than five days.[14] The impact these procedures have on taxpayers is illustrated by two actual TAS cases:

[12] Taxpayer files Form 8857, Request for Innocent Spouse Relief, if he or she believes only his or her spouse or former spouse should be liable for a tax debt, in whole or in part.

[13] Form 8302 may be filed with any tax return other than Form 1040, 1120, 1120-A, or 1120S to request a direct deposit refund of $1 million or more. Form 1040 filers request a direct deposit refund by completing the account information on that form. Form 1120, 1120-A, or 1120S filers request a direct deposit refund using Form 8050, Direct Deposit of Corporate Tax Refund. This includes a request for a refund of $1 million or more. Source: Form 8302 General Instructions (Rev. December 2001).

[14] IRM 3.17.79.3.3.3, Emergency Refunds.

- One taxpayer needed her refund to retrieve repossessed appliances and provide food for her 18 month-old child. The TAS case advocate submitted Form 3753 via express mail but the refund was still not deposited to the taxpayer's account until the eighth day, which is beyond the five-day timeframe prescribed in the IRM.
- In another emergency case, the refund was not deposited to the taxpayer's account until the eleventh day. This taxpayer also needed money for food for herself and her children, had received disconnect notices from utility companies, and had used her entire paycheck to cover her past due payment on her car, her only transportation for work.

If the emergency refunds for these two taxpayers had been processed at any of the other nine campuses that accept Forms 3753 by fax (followed by forwarding the originals the same day by express mail), their refunds would have been deposited to their accounts in less than five days as prescribed.

The Campus Consistency Project identified other differences between campuses, including:

- Requests for Integrated Data Retrieval (IDRS) printouts showing taxpayer name, address and account balance,[15]
- Requests for copies of the IDRS manual refund input screen, and
- The instruction to use block capital letters and not to use black ink in completing forms.

These inconsistencies are generally the result of various locally developed office procedures, which may take the form of a managerial inter-office memo, a locally developed subject matter desk guide, a local office job aide, or even verbal agreements. Local procedures are implemented when the Internal Revenue Manual (IRM) is outdated, unclear, ineffective, vague, or silent about particular processing circumstances. For example, the IRM does not provide instructions for issuing a direct deposit refund to a third party in cases when the taxpayer does not have a bank account. For extreme hardships, one site will accept a letter from the taxpayer authorizing a deposit to another person's account, provided the third party meets direct deposit verification requirements.

Examples of IRM "guidance gaps" filled by local procedures include the Accounting IRM, which requires documentation of the routing transit number and taxpayer account number to process a direct deposit refund.[16] If the taxpayer has provided this information on the original return, IRS employees can find the numbers by research without asking the taxpayer, yet must still contact taxpayers and ask them to provide a voided check,

[15] The Integrated Data Retrieval System (IDRS) enables IRS employees to have instantaneous visual access to taxpayer accounts currently active on the system. Some capabilities using IDRS include researching account information, requesting tax returns, and entering changes to accounts.

[16] IRM 3.17.79.5.4.2(9), Certifying ACH/Direct Deposit Hardship Refunds via ECS.

deposit slip, or bank letter in order for Accounting to process the direct deposit refund.[17] Thus, the IRM is outdated because new research tools allow the employee to ascertain the numbers without asking the taxpayer to provide information previously given on their original return.

The IRM does not contain procedures for issuing a taxpayer's refund when their direct deposit was misrouted due to IRS error. Campuses generally issue a manual refund, but written IRM procedures are needed. Nor does the IRM give clear guidelines for completion of Form 5792, Request for IDRS Generated Refund, for deceased taxpayers.

CONCLUSION

To ensure consistent treatment among all taxpayers, the IRS should provide its employees with approved and documented procedures in the IRM, which can be applied uniformly throughout the nation. Variance in procedures from one IRS campus to another results in inconsistent treatment of taxpayers and differing timeframes for processing their refunds.

IRS COMMENTS

IRS agrees that the manual refund approval process can be improved to ensure consistent and timely actions to assist those taxpayers meeting the criteria for such a refund. Local offices are not authorized to develop local procedures and should be submitting change requests (a standardized process) when procedures are unclear or missing from the Internal Revenue Manual (IRM).

The IRS has taken the following actions to correct the issues identified in the Campus Consistency Project:

- Completion of improvements to Form 8302, Direct Deposit of $1 Million or More, in October 2003.
- Development of a template and issuance of instructions to Accounting Campus employees announcing a standard review procedure. The procedures will be shared with employees involved in the manual refund process. IRM "alerts" have been issued to make immediate changes in the procedures below. These changes will be incorporated in the IRM in the April release.
- Emergency Refunds, due to "Life Threatening and Natural Disasters," are hardship criteria and are outlined in IRM 3.17.79.
- Campuses notified to accept and process FAXED manual refund requests via Forms 3753 as stated in the IRM 3.17.79.3.3.3. Originators must continue to sub-

[17] IMFOL is a code accessible by computer to IRS employees, which can provide a variety of information about a taxpayer's account.

mit original posting vouchers and supporting information to the campus approving the refund.

- Allow the use of the research tools such as the Individual Master File On-Line (IMFOL) for the bank routing transit number (RTN) and Account information when certifying certain types of hardship refunds.
- IRS will revise the IRM in January 2004 to include procedures to issue manual refunds for misrouted direct deposits due to an IRS error.
- IRS will add clarifying instructions for completion of Form 5792, Request for Integrated Date Retrieval System (IDRS) Generated Refund, for deceased taxpayers in the January 2004 IRM revision.

The Advocate notes that there are inconsistent instructions or guidance gaps in the campuses. There is a specific reference to third-party direct deposits where the IRM does not provide instructions for issuing a direct deposit refund to a third party in cases when the taxpayer does not have a bank account. We do provide guidance on this issue. It is IRM 3.17.79.5.4.2, which currently states, "that proof is needed that the account exists and is that of the taxpayer." Under current IRM instructions, no site should be authorizing deposit to an account not that of the taxpayer. This change would require a legal opinion from Chief Counsel.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the IRS for promptly taking actions to correct the manual refund inconsistencies outlined in this report, namely:

- *Revisions to Form 8302, Electronic Deposit of Tax Refund of $1 Million or More, should prevent future processing delays, previously caused by disparity in documentation requirements among the ten campuses.*
- *Immediate acceptance of faxed Forms 3753 at all ten Submission Processing Campuses should facilitate the processing of emergency refunds for taxpayers meeting hardship criteria in less than five days, as prescribed in the Internal Revenue Manual (IRM).*

The National Taxpayer Advocate is also pleased that the IRS plans to revise the IRM to provide instructions for issuing manual refunds in the following situations:

- *Processing direct deposit erroneous refunds due to IRS error.*
- *Providing instructions to complete Form 5792, IDRS Request for IDRS Generated Refund, for deceased taxpayers.*

- Advising *employees to use IDRS command code IMFOL as an additional tool to ascertain the taxpayer's bank account number and the routing transit number for their bank, in order to process a direct deposit refund.*

We will review the IRM for implementation of the above changes, and we look forward to future opportunities to work collaboratively to improve IRS processes for taxpayers.

RESPONSIBLE OFFICIALS

Henry O. Lamar, Commissioner, Wage and Investment Division
Dale Hart, Commissioner, Small Business/Self-Employed Division

DEFINITION OF THE PROBLEM

The Internal Revenue Service and the Social Security Administration jointly administer the Combined Annual Wage Reporting Program. The Internal Revenue Service is authorized to impose a penalty for intentional disregard of the filing requirements for information returns.[1] However, on average, 86 percent of the total penalty dollars are later abated.[2]

ANALYSIS OF PROBLEM

The Combined Annual Wage Reporting Program

The Internal Revenue Service and the SSA jointly administer the Combined Annual Wage Reporting (CAWR) program, which matches earnings and withholding of taxes. Employers are responsible for withholding income, Social Security, and Medicare taxes from their employees' wages. They must pay over the amounts withheld and file Form 941, Employer's Quarterly Federal Tax Return, with the IRS. The employer is also required to file Form W-2 Wage and Tax Statements for each employee, and Form W-3 (Transmittal of Income Tax Statements) with the Social Security Administration (SSA). Forms W-2 should include the same information summarized quarterly on the Form 941, while the Form W-3 summarizes the Forms W-2. Ideally, all information reported on Forms 941 should match the information on Forms W-2 for a given year. In practice, however, that is not always the case.

The Social Security Administration uses the information to post reported wages to individual Social Security accounts. The reported wages become the basis for computing Social Security benefits when the individual retires. The Internal Revenue Service uses the information to ensure that employers collect and pay the correct income tax, withholding, and advance earned income tax credit. The Social Security Administration matches Form 941 data with the data from Forms W-2 and W-3 and notifies the employer if any discrepancy is found. If the employer does not respond, the SSA forwards the matter to the IRS for further action.

The Internal Revenue Service uses its CAWR Automated System to manage and control the cases referred by SSA. The Internal Revenue Service researches the issue and tries to resolve the discrepancy before contacting the employer. If the IRS cannot resolve a dis-

[1] IRC § 6721(e)(2)(A).

[2] Enforcement Revenue Information System, Civil Monetary Penalty Data, IRC § 6721,1998-2002, ID #265, May 2003.

crepancy, it issues a notice advising the employer of the discrepancy and the potential penalty for intentionally disregarding filing requirements for information returns.[3] The employer has 45 days from the date of the notice to respond.[4] If the employer responds within the prescribed time, the matter may be resolved without penalty. If the employer does not respond within 45 days, the IRS automatically assesses the penalty for intentional disregard of the filing requirement for information returns.[5]

Information Return Filing Penalty

Employers are required to file complete and accurate information returns in a timely manner.[6] Internal Revenue Code section 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 to be shown 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.[7] There are exceptions to the amount of the penalty and to the maximum penalties if the filer corrects the failure within a specified time-period, if the filer's failures to include information are de minimis, or if the filer's gross receipts do not exceed certain amounts.[8]

Internal Revenue Code section 6721(e) provides for a higher penalty in the case of failures due to intentional disregard of filing requirements for information returns. Treas. Reg. 301.6721-1(f)(2) defines "intentional disregard," as knowing or willful. 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.[9]

The penalty is the greater of $100 per form required to be filed or 10 percent of the total amount required to be reported on the information returns.[10] There is no set maximum amount for this penalty. 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

[3] The IRS issues a CP 253 Notice to inform taxpayer of a discrepancy between information reported on the employment tax returns (i.e. Form 941) and the information reported on the Forms W-2 submitted to Social Security Administration (SSA).

[4] Internal Revenue Manual Section 4.19.4.9 (03-01-2003).

[5] Internal Revenue Manual Section 4.19.4.4 (03-01-2003) directives include an automatic assessment of the penalty prescribed under IRC § 6721(e) if no reply is received.

[6] IRC § 6724(d)(1)(A)(vii) defines the term information return as any statement of the amount of payments to another person required by section 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.

[7] IRC § 6721 (d) provides lesser penalty amounts for taxpayers (i.e. small businesses) with gross receipts of $5 million or less.

[8] IRC §§ 6721(b) through (d).

[9] Treas. Reg. 301.6721-1(f)(2)(ii).

[10] IRC § 6721(e)(2)(A) and Treas. Reg. 301-6721-1(f)(4).

and, how to compute the penalty.[11] However, the Internal Revenue Service only computes the penalty using the 10 percent method. The IRS' CAWR Automated Program cannot capture employee data from employment tax returns to determine the total number of Form W-2s an employer is required to file.[12] This problem may be contributing to high percentage of penalty dollar assessments and abatements.

The following table sets forth assessments and abatements of the intentional disregard penalty for fiscal years 1998 through 2002. The data suggests the IRS assesses a significant number of penalties. On average, 86 percent of the penalty dollar amounts and 47 percent of the number of penalties assessed are later resolved, reduced, or abated.

TABLE 1.20.1, ANALYSIS OF CIVIL MONETARY PENALTY (IRC 6721)[13]

Background

Fiscal Year	Number of Assessments	Penalty Assessments	Number of Abatements	Abatement Amounts	% Of dollars Abated	% Of Assessments Abated
2002	107,528	$2,786,049,682	48,221	$2,312,107,259	83	45
2001	84,946	$2,285,578,987	36,165	$2,024,070,650	89	43
2000	10,113	$1,137,494,644	5,785	$1,042,486,941	92	57
1999	88,593	$889,019,669	41,078	$719,155,886	81	46
1998	81,227	$822,165,934	37,290	$679,895,893	83	46

In the 1970s, Congress became increasingly concerned that the wage and payroll tax reporting system imposed a burden on employers, especially small businesses.[14] Before tax year 1978, employers were required to file detailed quarterly wage reports with the IRS. They also had to file individual W-2 forms for each employee after the close of the tax year. Congress estimated the cost to small businesses of filing quarterly employment tax returns was approximately $235 million (in 1975 dollars).[15] In 1976, Congress enacted legislation to address this burden.[16] The new provision authorized the IRS and SSA to enter into an agreement to process wage and payroll tax information starting with tax year 1978.[17]

[11] Statutory percentage includes the abovementioned 10 percent. Another statutory percentage is the 5 percent that applies to information returns for brokers, exchange of partnership interest, or disposition of donated property. See Treas. Reg. 301-6721-1(f)(4)(iv).

[12] Internal Revenue Manual Section 4.19.4.9(4), (3-01-2003).

[13] IRC § 6721 Data on Intentional Disregard Penalty from IRS Office of Enforcement Revenue Information System (ERIS), May 2003. ERIS captures data on civil monetary penalties.

[14] S. Rep. No. 550, 94th Cong., 1st Sess. 9 (1975).

[15] Id.

[16] Social Security Act-Hearings and Review Procedures, Pub. L. No. 94-202, § 232, 89 Stat. 1137, Jan. 2, 1976.

[17] Id.

Under present law, taxpayers are required to file quarterly tax returns (Form 941) with the IRS and annual wage reports and statements (Forms W-2 and W-3) with SSA. Employers report aggregate wage data to IRS and individualized earnings to SSA. This change to the wage reporting system may have reduced the filing burden for employers, but it increased the potential for discrepancies in the annual wage reports and the employer's quarterly tax returns.

During the 1980s, the two agencies encountered a number of problems, including budgetary constraints that hampered their efforts to achieve the agreed-upon goals of the CAWR program. The General Accounting Office estimated in a 1987 report that approximately 2.5 million employers were responsible for more than 3.5 million inaccurate, incomplete or missing wage reports.[18] In December 1989, Congress passed the Omnibus Budget Reconciliation Act of 1989 (OBRA), which amended IRC § 6721 and authorized the IRS to assess a civil penalty against taxpayers who ignored the requirements and did not file correct information returns within a reasonable time after receiving a request.[19]

In recent years, the Treasury Inspector General for Tax Administration (TIGTA) has identified a number of other problems in the CAWR program:

- In 2000, TIGTA found 491 employers that potentially reported $5.4 billion less in wages to IRS on Form 941 than on their Form W-2.[20]
- In 2002, TIGTA reported that the IRS did not penalize employers that filed wage and tax statements with inaccurate social security numbers, and did not act upon SSA data that identified the most egregious non-compliant taxpayers for tax years 1997 and 1998.[21]
- In 2003, TIGTA addressed IRS' responses to earlier reports and discussed the funding of the program and the problems with the unreliable IRS management information system.[22]

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. The Internal Revenue Service data establishes an unmistakable trend in the incorrect assessment of the penalty. Until the IRS makes sys-

[18] General Accounting Office, *Social Security: More Must Be Done to Credit Earnings to Individuals' Accounts*, GAO/HRD-87-52, September 17, 1987.

[19] Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7711, 103 Stat. 2106.

[20] Treasury Inspector General for Tax Administration (TIGTA), *Opportunities Exist To Identify Unreported Taxes From Employer's Quarterly Federal Tax Returns*, Reference # 2000-30-146, September 2000.

[21] Treasury Inspector General for Tax Administration (TIGTA), *The Internal Revenue Service Does Not Penalize Employers that File Wage and Tax Statements with Inaccurate Social Security Numbers*, Reference # 2002-30-156, September 2002.

[22] Treasury Inspector General for Tax Administration (TIGTA), *A Reliable Management Information System Is Needed Before Making Funding Decisions to Address Underreporting of Taxes on Employers' Quarterly Tax Returns*, Reference # 2003-30-175, September 5, 2003.

temic changes to this program, including education and outreach, it will continue to impose an unnecessary burden on taxpayers and be a drain on IRS resources.

IRS COMMENTS

Currently, when employers fail to respond to SSA inquiries regarding missing returns/information, SSA refers the employer to the IRS for enforcement action. Upon receipt of these referrals, the IRS researches available in-house information in an attempt to identify and/or resolve the missing or discrepant data. If discrepancies cannot be resolved through internal research, the Internal Revenue Service attempts to contact the employer to resolve. The contact letter requests that the employer provide specific information and outlines penalties associated with failure to comply. The employer is given 45 days to provide the missing information; if after 45 days the employer fails to respond, appropriate penalties are assessed. On average, 32 percent of all SSA referrals are resolved prior to assessment of the penalty. Once the penalties are assessed another notice advises the employer of the penalty that is due. Our analysis of data for FY 1998 through FY 2002 indicates that 46 percent of the total assessments for this period were abated after the employer contacted the IRS and provided the missing information.

IRS INITIATIVES TO RESOLVE PROBLEM

In an effort to reduce the number of assessments that ultimately are abated, the IRS, in conjunction with the SSA, has increased our education and outreach efforts to employers. Over the past few years the IRS and the SSA have conducted educational workshops, as part of the National Tax Forums. These joint information-reporting seminars promote better employer reporting practices and include discussions on Forms 1099, 94X and Forms W-2/W-3. The Internal Revenue Service is also a regular contributor to the "IRS/SSA Reporter," a magazine for employers that provides updates on reporting requirements.

The Internal Revenue Service has also developed Publication 1066, "Small Business Tax Workshop" which is used in the classroom version of the Small Business Tax Workshop and addresses various aspects of employment tax obligations, including federal tax deposits and preparation of W-2 and W-3 documents. The Internal Revenue Service recently launched a program to leverage these workshops through partner organizations, increasing the number of taxpayers who can benefit from the workshop material. The Small Business Workshops are also available online at http://www.irs.gov/smallbiz and several of our partners have created links to our site for small business owners. These education initiatives should improve overall employer filing and timeliness.

The Internal Revenue Service has also made modifications to the CAWR program. We have eliminated any automatically generated assessment of $1 million or more since we found a high instance of reporting errors in this category. A manual system now ensures the accuracy of these proposed assessments.

The Internal Revenue Service is also reviewing and modifying the four correspondence letters (98C Wages reported per SSA; No Record of Return: Form 941,943, 945, and SCH H; and 99C Wage Discrepancy per SSA: Information /Verification Requested) associated with CAWR to ensure that they provide employers with clear, concise information to make each contact more effective.

Finally, the program is being enhanced to allow taxpayers to provide information via facsimile so they respond more quickly to the IRS's requests for missing information and facilitate the resolution of discrepancies.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate supports the IRS and the SSA in their increasing education and outreach efforts to inform employers of their filing responsibility for information returns.[23] *Additionally, the National Taxpayer Advocate applauds the IRS' recognition of a problem with accuracy of notices with penalty amounts of $1 million or more. The IRS is taking steps in the right direction to reduce the high instance of reporting errors in this category. Reviewing large dollar penalty notices before mailing to taxpayers will significantly impact all taxpayers and the IRS, but more specifically large and mid-sized businesses.*

In fiscal year 2002, the IRS assessed $1.4 billion and abated $1.3 billion in penalties against large and mid-size businesses for intentional disregard of filing requirements for information returns.[24] *An analysis of taxpayers' accounts and concerns raised by external stakeholders revealed the problems range from simple Employer Identification Number (EIN) problems, math errors on tax returns or wage statements to complex issues such as mergers and acquisitions, consolidations and other reorganizations, and use of common pay agents. The Office of Systemic Advocacy within the Taxpayer Advocate Service is working on a joint advocacy project with the IRS Large and Mid-sized Business (LMSB) Division to address CAWR penalties assessments. The Small Business and Self-Employed Division has agreed to partner with TAS to address systemic issues in TAS CAWR/FUTA cases.*

[23] A Memorandum of Understanding between the two agencies provides for jointly sponsored educational workshops intent on reducing the number of reconciliation cases by helping employers to better understand the reporting requirements.

[24] Office of Revenue Analysis, ERIS Data as of May 2003 - IRC Section 6721 - Intentional Disregard Penalty. Penalty asserted under IRC § 6721(e).

RECOMMENDATIONS

- *In 1978, the IRS and the SSA entered into a cooperative agreement (Memorandum of Understanding or MOU). This MOU set forth the responsibility that each agency assumed in reconciling wage statements. The MOU has been revised since 1978, but the underlying premise and program objectives have remained intact. Currently, the IRS and the SSA are reviewing and rewriting the MOU. The National Taxpayer Advocate applauds this effort and urges the agencies to devote their attention to this priority issue. It is imperative that both agencies agree to changes in the reconciliation process that improve the system for all taxpayers and reduce its cost in government resources.*
- *IRS and SSA education initiatives should focus on making the reconciliation process transparent to employers, to promote awareness of filing responsibility and the consequences of the penalty. Transparency is one of the critical elements of a representative government, and enhances taxpayer confidence in the tax administrative system.*
- *The IRS must address the computer program and/or software problem that impedes its ability to administer the penalty properly.*
- *The IRS must follow up on its review of notices with penalty amounts of $1 million or more to determine the effectiveness of the initiative and share the results with the LMSB division.*

INTRODUCTION

The National Taxpayer Advocate has a statutory requirement that is unique within the Internal Revenue Service. The Advocate is directed by Section 7803 (c)(3)(B)(viii) of the Internal Revenue Code to formulate and present in the Annual Report to Congress, proposals for legislative action that will ameliorate or eliminate problems affecting Taxpayers. Frequently, these difficulties impede a taxpayer's ability to comply with federal law. Our mandate is to identify actual and potential barriers confronting taxpayers, and to propose viable legislative options.

Status of 2001 and 2002 Legislative Recommendations - 108th Congress

2003 Legislative Recommendations - 108th Congress

1. Confidentiality and Disclosure of Returns and Return Information - IRC §6103
2. Tax Withholding on Non-Wage Workers
3. Federal Tax Return Preparers: Oversight and Compliance
4. Filing Due Date of Partnership and Certain Trusts
5. Attainment of Age

RECOMMENDATIONS

LEGISLATIVE RECOMMENDATIONS

STATUS OF 2001 & 2002 LEGISLATIVE RECOMMENDATIONS 108TH CONGRESS

Recommendation	Bill No.	Sponsor	Date	Current Status
Family Issues				
Uniform Definition of a Qualifying Child	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee
	S 755	Baucus	4/1/2003	Referred to the Senate Finance Committee
	S 1054	Grassley	5/16/2003	Returned to Calendar. Calendar No. 97
	HR 2718	S. Brown	7/14/2003	Referred to the Ways & Means Committee
	S 1434	Lincoln	9/2/2003	Placed on Senate Legislative Calendar
Means Tested Public Assistance Benefits	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee
Alternative Minimum Tax				
Repeal	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 Senate Finance Committee
	HR 3060	N. Smith	9/10/2003	Referred to the Ways & Means Committee
Index AMT exemption	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee

STATUS OF 2001 & 2002 LEGISLATIVE RECOMMENDATIONS 108TH CONGRESS

Recommendation	Bill No.	Sponsor	Date	Current Status
Tax Preparation				
Matching Grants for LITC for Return Preparation	S 476	Grassley	2/27/2003	Referred to the Senate Finance Committee
	S 685	Bingaman	3/21/2003	Referred to the Senate Finance Committee
	S 882	Baucus	4/10/2003	Referred to the Senate Finance Committee
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Regulation of Income Tax Return Preparers	S 685	Bingaman	3/21/2003	Referred to the Senate Finance Committee
Low Income Taxpayer Clinics -- funding & promotion	HR 1528	Portman	6/20/2003	Referred to the Senate
	S 882	Baucus	4/10/2003	Referred to the Senate Finance Committee
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Small Business Issues				
Married Couples as Business Co-owners	HR 1528	Portman	6/20/2003	Referred to the Senate
	S 842	Kerry	4/9/2003	Referred to the Senate Finance Committee
	HR 1640	Udall	4/3/2001	Referred to the Ways & Means Committee
	HR 1558	Doggett	4/2/2003	Referred to the Ways & Means Committee
Health Insurance Deduction/Self-Employed Individuals	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

RECOMMENDATIONS

LEGISLATIVE RECOMMENDATIONS

STATUS OF 2001 & 2002 LEGISLATIVE RECOMMENDATIONS 108TH CONGRESS

Recommendation	Bill No.	Sponsor	Date	Current Status
Small Business Issues				
Income Averaging for Commercial Fishermen	S 665	Grassley	3/19/2003	Referred to the Senate Finance Committee
	S 842	Kerry	4/29/2003	Referred to the Senate Finance Committee
	HR 2896	Thomas	7/25/2003	Placed on Union Calendar No. 226
	S 1831	G. Smith	11/16/2003	Referred to the Senate Finance Committee
Office of the National Taxpayer Advocate				
Confidentiality of Taxpayer Communications	HR 1528	Portman	6/20/2003	Referred to the Senate
Access to Independent Legal Counsel	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
IRS Collection Procedures				
Return of Levy or Sale Proceeds	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Reinstatement of Retirement Accounts	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Partial Payment Installment Agreements	S 19	Daschle	1/7/2003	Referred to the Senate Finance Committee
	S 289	Grassley	2/4/2003	Referred to the Senate Finance Committee
	S 351	Grassley	2/11/2003	Placed on Senate Legislative Calendar.

STATUS OF 2001 & 2002 LEGISLATIVE RECOMMENDATIONS 108TH CONGRESS

Recommendation	Bill No.	Sponsor	Date	Current Status
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	S 882	Baucus	4/10/2003	Referred to the Senate Finance Committee
	S 1054	Grassley	5/16/2003	Returned to Calendar. Calendar No. 97
	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 2896	Thomas	7/25/2003	Placed on Union Calendar No. 226
	S 1434	Lincoln	9/2/2003	Placed on Senate Legislative Calendar
Penalties & Interest				
Interest Abatement on Erroneous Refunds	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
First Time Penalty Waiver	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Federal Tax Deposit (FTD) Avoidance Penalty	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	HR 1528	Portman	6/20/2003	Referred to the Senate
	S 882	Baucus	4/10/2003	Referred to the Senate Finance Committee
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Tolling the Statute of Limitations 7811(d)	HR 1528	Portman	6/20/2003	Referred to the Senate
	S 882	Baucus	4/10/2003	Referred to the Senate Finance Committee
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee

1 CONFIDENTIALITY AND DISCLOSURE OF RETURNS AND RETURN INFORMATION – IRC SECTION 6103

PROBLEM STATEMENT

Since the mid-1970s, the confidentiality of taxpayer identity, returns and return information ("tax information") has been a congressionally mandated cornerstone of U.S. tax administration. The importance of confidentiality to the fair and effective administration of the tax system cannot be overstated. The United States asks its taxpayers to come forward and voluntarily report their taxable income and pay the appropriate amount of tax due on that income. In exchange for taxpayers providing this highly personal information to the tax administrator, the government promises to hold that information in confidence, and to prohibit or limit its use by other federal agencies.

In 1976, Congress determined that the Secretary of the Treasury could disclose taxpayer information only when explicitly authorized by Congress. In amending Internal Revenue Code section 6103, Congress signaled that it would carefully weigh the demonstrated need for the proposed disclosure against the taxpayer's right and expectation of privacy and the impact such disclosure would have on the fair and effective administration of the tax system.

Despite this underlying approach, IRS tax information is increasingly viewed by other federal and state agencies, including law enforcement agencies, as the mother lode of data necessary for administering their respective missions. Yet in many, if not all, cases, disclosures to other government agencies for purposes of improving the administration of their programs can have the unfortunate side effect of deterring taxpayers from fulfilling their tax obligations, thereby undermining both tax administration and the usefulness of tax information for the requesting entity.

In some instances, IRC § 6103 limits disclosure of tax information to agency officials. If disclosure to contractors and agents is permitted, however, restrictions and safeguards on use of the data may limit the agency's efficient use of contractors. As a result, agencies turn to the use of systemic taxpayer consents to disclosure as a means of obtaining and sharing tax information with contractors and agents, since tax information disclosed pursuant to a consent is not subject to the Code's safeguard provisions and re-disclosure limitations.

A complete discussion of the difficult policy and administrative concerns inherent in IRC § 6103 and the confidentiality of tax information is beyond the scope of this Report.

The National Taxpayer Advocate intends to highlight certain issues that should be of concern to all taxpayers.[1]

EXAMPLE

Internal Revenue Code section 6103 is among the longest provisions in the Code. Section 6103 has 17 subsections (§§ 6103(a) through (q)), all but four of which discuss exceptions to the general rule of non-disclosure of tax information found in IRC § 6103(a). Within the 17 subsections, there are close to 400 paragraphs and subparagraphs setting forth the detailed rules regarding the disclosure of tax information. Two of the subsections, IRC §§ 6103(i) and 6103(l) which provide rules for disclosure of tax information for reasons other than tax administration, account for almost one-half of the paragraphs and subparagraphs contained in this section of the Code.

RECOMMENDATION

The National Taxpayer Advocate recommends that disclosure of returns and return information be limited to those rare instances in which an agency has demonstrated a compelling need for that information which cannot be reasonably obtained from another source. All such disclosures should be subject to the appropriate safeguards and procedures for maintaining the confidentiality of the tax information in the hands of another agency. The Code should specify limits on the amount and use of disclosed information, and make all violations of those limits subject to civil and criminal sanctions.[2]

Disclosure provisions should be designed so as to minimize access to such information by contractors. Where contractors must be used by an agency, the disclosures should be limited to a "fact of filing" or "match/mismatch" acknowledgement. If such a narrow disclosure provision is unworkable, then the disclosure of tax information should be limited to the number of nontax administration contractors that the IRS can adequately safeguard.

Prior to any statutory expansion of disclosure exceptions, Treasury and the IRS should conduct a pilot of the proposed program. The pilot should be conducted for a number of years in order to measure the true impact that the proposed disclosure may have on voluntary tax compliance by the participants.

[1] For a thorough analysis and discussion of taxpayer confidentiality and disclosure issues, see *Department of Treasury, Report to the Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions. Vol. I: Study of General Provisions*, October 2000 (hereinafter, "Treasury Report"); and Staff of the Joint Committee on Taxation, Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998. Vol. I: Study of General Disclosure Provisions, JCS-1-00, (January 28, 2000) (hereinafter, "JCT Study"). The National Taxpayer Advocate supports many of the specific recommendations set forth in those reports.

[2] Specific statutory changes to implement this recommendation are described in the Explanation of Recommendation section, *infra.*

Any initial statutory authorization should be subject to a 5-year sunset provision. Prior to reauthorization, Treasury and the IRS should prepare a report assessing the impact the provision has had on taxpayer privacy and taxpayer voluntary compliance as well as whether advances in public or private sector technology have reduced the need for taxpayer information.

Finally, every ten years, the Congress should direct the Secretary of the Treasury to review all disclosure exceptions in IRC § 6103, make recommendations about their continued necessity, including suggesting repeal where technological or private sector advances have minimized the need for the disclosure, and report such findings and recommendations to the Joint Committee on Taxation.

PRESENT LAW

Introduction: Overview of Statutory Framework

Internal Revenue Code section 6103 provides that, in general, returns and return information ("tax information") are confidential. Section 6103 also provides for disclosure of return and return information in excepted circumstances. In balancing the competing policy objectives of confidentiality and disclosure, the Code generally requires that where disclosure is deemed necessary, it must be done with appropriate safeguards to prevent misuse or subsequent disclosure.

There are three separate statutory regimes relevant to determining whether returns and return information are disclosed:

- the Internal Revenue Code,
- the Freedom of Information Act (FOIA),[3] and
- the Privacy Act of 1974.[4]

No discussion of tax information confidentiality is complete without consideration of the effect of the Freedom of Information Act (FOIA) and the Privacy Act of 1974. Like Section 6103, the Privacy Act is a confidentiality statute, establishing the general rule of confidentiality for individually identifiable information, and providing civil and criminal penalties for violations thereof. For individual taxpayers, these Code and Privacy Act provisions overlap or may even conflict. Both the Joint Committee on Taxation and Treasury, in their respective studies, recommended that it "be clarified that sections 6103 and 7431 preempt the Privacy Act with respect to the disclosure of returns and return information and the remedy for unauthorized disclosure."[5]

[3] 5 U.S.C. § 552. The purpose of FOIA is to provide the citizenry with access to government information. FOIA rests on the concept that the more informed people are about their government the better they will be governed.

[4] 5 U.S.C. § 552a. Enacted in 1974, the Privacy Act came out of the aftermath of Watergate. The Act is intended to regulate the collection, use, dissemination, and maintenance of personal information by Federal agencies.

[5] JCT Study, infra note 1, at 204. See also Treasury Report, infra note 1, at 42.

On the other side of the spectrum, the FOIA is a disclosure statute, affirmatively obligating the IRS to make certain information available for public inspection and allowing other information to be made available upon written request, unless specific statutory exceptions or exclusions apply. The basic purpose of the FOIA is to "ensure an informed citizenry, vital to the functioning of a democratic society, needed to check against corruption and to hold the governors accountable to the governed."[6] But Congress recognized that release of certain information would not serve the basic purpose of the FOIA or would do harm to other important interests, taxpayer privacy among them.[7] Again, both the Joint Committee on Taxation and Treasury recommended that the "principle that section 6103 is a [FOIA] exemption 3 statute be codified to avoid further litigation or uncertainty over the issue and to ensure the consistent administration of section 6103 as it relates to the FOIA and vice versa."[8]

Three provisions of the Internal Revenue Code generally govern disclosure of return and return information:

- Section 6103,
- Section 6104, and
- Section 6110.[9]

The statutory schematic of Section 6103 is as follows:[10]

1. General rule on confidentiality.
2. Exceptions to the general rule authorized by the Code.
3. Record keeping and physical safeguard provisions.
4. Civil and criminal sanctions for unauthorized inspections and disclosures.

Section 6103(a) establishes the general rule that returns and return information are confidential and cannot be disclosed except as authorized by the Code. Section 6103(b)

[6] NLRB v. Robbins Tire & Rubber Co., 437 U.S. 214, 242 (1978).

[7] See 5 U.S.C. § 552(b)(3) (information falling within certain qualifying statutes is exempt under the FOIA).

[8] Treasury Report, supra note 1, at 40, See also JCT Study, supra note 1, at 200. In general, the National Taxpayer Advocate concurs with these recommendations, in accord with the discussion in the Treasury Report at 38-42.

[9] IRC § 6104 covers publicity of information required from certain exempt organizations and certain trusts. IRC § 6110 covers public inspection of written determinations.

[10] Pub. L. No. 94-455 (1976). Prior to 1977, tax returns were considered public records and open to public inspection by executive order. The Tax Reform Act of 1976 amended Section 6103 to exclude return and return information from the category of public records and deemed them confidential.

provides definitions for terms such as "return"[11] and "return information."[12] Subsections (c) through (o) set forth the exceptions to the general rule of confidentiality, and are summarized in Table 2.1.1 below.

TABLE 2.1.1

Code Section	Description of Exception to Confidentiality
6103(c)	Disclosure of returns and return information to designee of taxpayer.
6103(d)	Disclosure to state tax officials and State and local law enforcement agencies.
6103(e)	Disclosure to persons having a material interest.
6103(f)	Disclosure to committees of Congress.
6103(g)	Disclosure to President and certain other persons.
6103(h)	Disclosure to certain Federal officers and employees for purposes of tax administration.
6103(i)	Disclosure to Federal officers or employees for administration of Federal laws not relating to tax administration.
6103(j)	Statistical use.
6103(k)	Disclosure of certain returns and return information for tax administration purposes.
6103(l)	Disclosure of returns and return information for purposes other than tax administration.
6103(m)	Disclosure of taxpayer identity information.
6103(n)	Certain other persons.[13]
6103(o)	Disclosure of returns and return information with respect to certain taxes.

[11] A "return" means any tax or information return, estimated tax declaration, refund claim as required or permitted by law, and any amendment or supplement thereto, including supporting schedules or attachments that are part of a filed return. IRC § 6103(b)(1).

[12] The term "return information" is broadly defined in the Code. It includes:

- A taxpayer's identity, and the nature, source, and amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, as well as whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of a liability (or amount thereof) of any person for tax, penalty, interest, fine, forfeiture, or other imposition or offense under Title 26 of the United States Code. IRC § 6103(b)(2)(A).
- Any written document or background file document relating to a written determination that is not open to public inspection under IRC § 6110. IRC § 6103(b)(2)(B).
- Any advance pricing agreement between the taxpayer and the Secretary, and any background material to that agreement. IRC § 6103(b)(2)(C).
- Any agreement under IRC § 7121 (closing agreement) or other similar agreement, along with background material. IRC § 6103(b)(2)(D).

Return information does not include any data that is in a form that cannot be associated with or otherwise identify the taxpayer, either directly or indirectly.

[13] Disclosure is permitted to other persons to the extent necessary in connection with processing, storage, transmission, and reproduction of returns and return information, and with programming, maintenance, repair, testing and procurement of equipment for purposes of tax administration.

Record keeping and physical safeguard requirements for the IRS and entities to which tax information is disclosed are outlined in IRC § 6103(p). Criminal sanctions for the willful unauthorized disclosure and inspection of returns and return information are set forth in IRC sections 7213 and 7213A, respectively.[14] Section 7341 provides for a civil cause of action in Federal District Court for persons whose return and return information has been knowingly or negligently inspected or disclosed without authorization.[15]

Disclosure Report for 2002

In accordance with Internal Revenue Code section 6103(p)(3)(C), within 90 days after the close of each calendar year, the Secretary of the Treasury sends to the Joint Committee on Taxation a comprehensive report on the number of certain disclosures of returns and return information for that particular year. The Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2002 was issued by the Joint Committee on Taxation on April 1, 2003.[16] Highlights of the report include:

Total number of Disclosures • Tape Extracts • Other Disclosures		6,622,979,668[17] • 6,621,463,308 • 1,516,360
Disclosure To/For	IRC § 6103 Subsections	Number of Disclosures
Total number of disclosures to states	6103(d)	5,248,251,124[18]
Disclosure to Child Enforcement Agencies	6103 (l)(6)	8,135,344[19]
Disclosures to US Attorneys, FBI, DEA, other	6103(i)(1)	43,599
Terrorist related disclosures to FBI	6103(i)(3)(B)	12,236
Disclosures to Federal Agencies	6103(l)(3)	94

[14] IRC § 7213 provides criminal penalties for the willful, unauthorized disclosure of returns and return information by Federal and State employees and officers, and others. Similarly, IRC § 7213A provides criminal penalties for the willful, unauthorized inspection of such information. Under both provisions, where the willful, unauthorized disclosure or inspection was committed by a Federal officer or employee, that officer or employee must be dismissed from office or discharged from employment, upon conviction.

[15] IRC § 7431(a)(1) provides that a person can bring a civil action against the United States in Federal District Court for damages if a Federal employee commits a knowing or negligent unauthorized inspection or disclosure of a return or return information. If a person other than a Federal employee commits such an act, the taxpayer may bring a civil action for damages in Federal District Court against that person. IRC § 7431(a)(2). Inspections and disclosures which are requested by the taxpayer, or based upon an erroneous, but good faith, interpretation of IRC § 6103, do not result in liability. IRC § 7431(b).

[16] Joint Committee on Taxation, Disclosure Report For Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2002, April 1, 2003, JCX-25-03.

[17] Tape Extracts – disclosures made by extracting information from the IRS' Master Files tapes. Other Disclosures – disclosures made by furnishing transcripts of records, permitting inspection of records, furnishing photocopies of records, oral disclosures, and disclosures by means of correspondence without furnishing a copy of the record. Also includes disclosures from locally automated files.

[18] States and Local Tax Authorities are the largest recipients of IRS tax information leading many to believe the IRS is the lending library of the state and local tax community. *See* George Guttman, *The Confidentiality Statute Needs Rethinking*, Tax Notes, Jan. 17, 2000, p. 318.

Historical Background

Two main themes run through the history of confidential treatment of taxpayer returns. The first concept is that tax returns constitute public records, the access to which was controlled by the Executive Branch, as permitted by Treasury regulations or by Presidential Order. This approach dominated the treatment of tax returns during the 100-year period prior to the enactment of the Tax Reform Act of 1976.

The second theme reflects Congress' and the public's increasing concern about the general use of tax information for non-tax administration purposes. Under this approach, codified in 1976 in IRC § 6103, tax information is confidential and cannot be disclosed unless explicitly authorized by Congress as set forth in the Internal Revenue Code. Thus, Congress eliminated the Executive Branch's discretion over access to tax information in 1976 and gave it to itself.

The evolution of tax information from being viewed as a public record to one that is confidential can prove helpful as Congress addresses current challenges to the confidentiality of returns and return information.[20]

Early Legislation: 1862 to 1976

From 1862, following Congress' enactment of the first federal income tax to finance the Civil War, tax returns were designated public records.[21] District assessors were required to compose an annual list of all persons liable to pay tax and the respective amounts due. These lists were available for public inspection for 15 days and were also required to be publicized in the county newspapers and in "at least four public places" in each county in the collection district. In 1864, Congress required these lists to be made available to anyone who requested to see them.[22] Shortly thereafter, newspapers began publishing incomes of leading citizens in their communities.

The publicity of tax information was apparently designed to notify taxpayers of their tax liabilities and when they would be collected. The practice, however, engendered significant debate and was halted in 1870, although collectors and assessors could publish

[19] All of the disclosures to Child Support Enforcement Agencies are made via tape extracts.

[20] For detailed discussions of the legislation evolution of IRC § 6103, see Treasury Report, supra note 1, at 15-22; JCT Study, supra note 1, Appendix A: Statutory Evolution of Section 6103, at 246; Report on Administrative Procedures of the Internal Revenue Service to the Administrative Conference of the United States, S. Document 266, 94th Cong., 2d Sess. 821-1135 (October 1975); and Zaritsky, *Legislative History of Tax Return Confidentiality: Section 6103 of the Internal Revenue Code of 1954 and Its Predecessors*, U.S. Congressional Research Service, Library of Congress, D.C.: 74-211A (1974).

[21] Act of July 1, 1862, ch. 119, 12 Stat. 432, 437.

[22] Act of June 30, 1864, 13 Stat. 218, 228.

general statistics, pursuant to the rules and regulations promulgated by the Commissioner of Internal Revenue.[23] Shortly thereafter, in 1872, the income tax was not re-enacted, in part attributable to the controversy over publicity of tax returns.

With the reinstatement of the income tax in 1894, Congress prohibited the publication of income tax returns except where specifically authorized by law. The United States Supreme Court declared the 1894 income tax unconstitutional in 1895.[24]

In 1909, Congress declared corporate excise tax returns to be public records and open to inspection, but also prohibited any Federal employee from disclosing such information unless specifically directed by the President.[25] One year later, it limited access to only those persons who were authorized by the President, under rules and regulations prescribed by the Secretary of the Treasury.[26]

Following the ratification of the Sixteenth Amendment on February 3, 1913, Congress not only made tax information available for inspection upon order of the President but also permitted inspection of corporate returns by state officers without Presidential permission.[27] Thus, the Tariff Act of 1913 reconciled two apparently conflicting concepts – that tax returns were public records open to inspection, but that such inspection was controlled by the President, under rules and regulations prescribed by the Secretary of the Treasury and approved by the President.

In 1917, district collectors were required to make annual lists of the name and post office addresses of all persons in the district who made a return.[28] These lists were once again available for public inspection by persons pursuant to Presidential Order or by state officials. One-percent shareholders of a corporation were also authorized to inspect the returns of that corporation and its subsidiaries.

During this early period of taxation, the publication of tax returns and tax information were hotly debated. Proponents of publication believed that it would lead to more accurate reporting and, at least with respect to corporations, was necessary in order to limit unfair business practices. This approach was founded on the concept of taxpayers being "members of a great partnership, and it is the right of each to know what every other member is contributing to the partnership and what he is taking away from it."[29] The

[23] Treasury Decision (April 5, 1870), in Internal Revenue Record and Customs Journal, vol. XI, No. 15, whole No. 275 (April 9, 1870).

[24] Pollack v. Farmers Loan and Trust Co., 157 U.S. 429 (1895).

[25] Act of August 5, 1909, 36 Stat. 11, 116-17 (Payne-Aldrich Tariff Act of 1909).

[26] Act of June 17, 1910, 36 Stat. 468, 494.

[27] Tariff Act of 1913, ch. 16, 38 Stat. 114, 177.

[28] Revenue Act of 1918, Section 257, Feb. 24, 1919.

[29] Rogovin, *Privacy and Income Tax Returns,* The Washington Post, October 13, 1974, at C4.

Treasury Department, on the other hand, maintained that because it "must rely upon the good faith of those reporting income, . . . this reliance is entirely justifiable, principally because the taxpayer knows that in making a truthful disclosure of the sources of his income, information stops with the government. It is like confiding in one's lawyers."[30]

With the Revenue Act of 1924, Congress came down on the side of publication.[31] The Act required the Commissioner to make publicly available lists of the name, address, and amount of tax paid by each person filing an income tax return. The Supreme Court upheld newspapers' right to publish these lists, and many did so.[32]

In 1934, following a tax evasion scandal, Congress authorized the notorious "pink-slip" procedure.[33] Each taxpayer was required to file with his return a pink slip that summarized the taxpayer's gross income, total deductions, net income and tax due. Pink slips were open to public inspection for three years from the filing date. Congress repealed the provision before it was implemented, in part over concerns about the safety of taxpayers from kidnappers, blackmailers, and the "malicious and idle curious."[34]

In the 1920s, Treasury regulations made individual returns available to other government agencies.[35] The Revenue of Act of 1926 created the Joint Committee on Taxation and granted it access to tax return data.[36] Access was previously granted to the House Committee on Ways and Means and the Senate Committee on Finance in 1924.[37]

It was not until 1966 that Congress repealed the public lists requirement and replaced it with an authorization for the IRS to confirm, in response to a public inquiry, whether the taxpayer had or had not filed a return for any given period.[38] Thus, until the mid-1970s, access to returns as public records was controlled by the President. Under regulations,

[30] Treasury Report, supra note 1, at 19, attributing quote to Secretary of the Treasury Mellon.

[31] Act of June 2, 1924, ch. 234, 43 Stat. 253, 293.

[32] United States v. Dickey, 268 U.S. 378 (1925). In 1926, Congress eliminated the provision permitting the publication of the amount of tax assessed. Act of February 26, 1926, ch. 27, 44 Stat. 9, 52.

[33] Act of May 10, 1934, ch. 277, 48 Stat. 680, 698.

[34] See JCT Study, supra note 1, at 254.

[35] Corporate returns were available to other government agencies as of 1910. Treasury Report, supra note 1, at 20.

[36] Revenue Act of 1926, supra note 32 § 1203(d).

[37] Revenue Act of 1924, supra note 31 § 257(A). The Committees could request tax returns or data from the Secretary and inspect them through designated agents and examiners. Further, the Committees could give this information to other committees of the House and Senate.

[38] This provision occurred primarily because the IRS was converting its recordkeeping to microfilm, which would make taxpayers' social security numbers available for public inspection.

persons with material interest[39] and department heads[40] were granted access. Further, tax returns were available for use in legal proceedings in which the United States was a party.

During the 1970's, Congressional and public concern over the use of personal information held by the government led to the enactment of the Privacy Act of 1974.[41] In the tax arena, two significant events triggered a comprehensive review of the rules governing confidentiality of tax returns and tax return information. First, President Nixon issued two executive orders authorizing the Department of Agriculture to inspect all farmers' tax returns "for statistical purposes."[42] Second, the Watergate hearings revealed White House attempts to obtain tax and return information of taxpayers, including supporters under IRS audit and persons on the "enemies" list.[43] In this atmosphere, the Senate Finance Committee issued its report on H.R. 10612, the Tax Reform Act of 1976, proposing significant revisions to the treatment of tax returns and other information.[44] The Senate's bill was adopted with little revision in conference.[45]

Tax Reform Act of 1976

Following the enactment of the Tax Reform Act of 1976[46] (TRA 76), returns and other information were no longer classified as public records. With TRA 76, Congress conducted a comprehensive review of then-current practices regarding disclosures and incorporated some exceptions to this general rule of confidentiality. The Act effected an important shift of power: determinations regarding disclosure no longer resided in the executive branch. Instead, all such exceptions would be authorized by Congress in the Internal Revenue Code.

[39] Persons with material interests included an individual or his attorney in fact; either spouse of a joint return upon proof of relationship; the administrator, executor, or trustee (or attorney in fact) of a deceased taxpayer's estate; an heir at law or next of kin (or attorney in fact) upon a showing of a material interest affected by the information sought (and at the Commissioner's discretion); partners, estate, and next of kin of deceased partners; trustee, beneficiary, estate of beneficiary, and next of kin of beneficiary of trust; and corporate president, vice president, secretary, treasurer or any other principal officer. Treas. Reg. § 301.6103(a)-1(c) (1975).

[40] Information was available to department heads only for official business and upon written request, outlining the need for access.

[41] Under the Act, the Privacy Protection Study Commission was directed to study and recommend the appropriate framework for disclosure of tax return information.

[42] Exec. Order Nos. 11697, 11709. At hearings, Justice Department officials testified that these orders were models for future orders authorizing tax return inspections by other federal agencies. See Treasury Report, supra note 1, at 20.

[43] See Treasury Report, supra note 1, at 20-21; JCT Study, supra note 1, at 255-56. One of the proposed Articles of Impeachment against President Nixon alleged that the President had "endeavored to obtain from the Internal Revenue Service, in violation of the constitutional rights of citizens, confidential information contained in income tax returns for purposes not authorized by law. . . ." Report on the Impeachment of Richard M. Nixon, President of the United States, H.R. Rep. No. 93-1305, at 3 (1974).

[44] S. Rep. No. 94-938, 94th Cong., 2d Sess. (1976).

[45] H.R. Conf. Rep. No. 94-1515, 94th Cong., 2d Sess. (1976).

[46] Pub. L. No. 94-455, 90 Stat. 1667 (1976).

The Senate Report spelled out Congress' concerns:

> The committee has reviewed each of the areas in which returns and return information are now subject to disclosure. . . . With respect to each of these areas, the committee has tried to balance the particular office or agency's need for the information involved with the citizen's right to privacy and the related impact of the disclosure upon the continuation of compliance with our country's voluntary assessment system.[47]

The Tax Reform Act of 1976 significantly changed practice in several areas that are relevant to the current discussion – disclosure to federal agencies in non-tax criminal cases; disclosure to federal agencies in civil matters; inspection by federal agencies; and procedures and safeguards. The Act adopted then-existing practices in certain miscellaneous areas, either as a matter of policy or after determining that the need for such disclosure outweighed the possible invasion of taxpayer privacy, such as the release of tax information to Federal, state, and local child support enforcement offices to the extent such information is not available from another source.[48]

RRA 98 and Disclosure Studies

The Internal Revenue Service Restructuring and Reform Act of 1998 directed the Joint Committee on Taxation and the Department of the Treasury to conduct separate studies on the scope and use of provisions regarding taxpayer confidentiality and to report the findings of their studies, together with recommendations.[49] Congress directed the studies to address:

(1) The present protections for taxpayer privacy;

(2) The need for third parties to use tax return information;

(3) Whether greater levels of voluntary compliance may be achieved by allowing the public to know who is legally required to file tax returns, but does not file tax returns;

(4) The interrelationship of the taxpayer confidentiality provisions in the Internal Revenue Code of 1986 with such provisions in other Federal law, including Section 552 of Title 5, United States Code (commonly known as the "Freedom of Information Act");

(5) The impact on taxpayer privacy of the sharing of income tax return information for purposes of enforcement of State and local tax laws other than income tax laws, and including the impact on the taxpayer privacy intended to be protected at the Federal, State, and local levels under Public Law 105-35, the Taxpayer Browsing Protection Act of 1997; and

[47] S. Rep. No. 94-938, supra note 39, at 318.

[48] Pub. L. No. 94-455, § 1202(a)(1), 90 Stat. 1680 (1976) [IRC § 6103(l)(6]. Such information was not available to third parties in litigation, or to agents of child support enforcement offices. Check cite

[49] Pub. L. No. 105-206, § 3802, 112 Stat. 782 (1998) [IRC § 6103]

(6) Whether the public interest would be served by greater disclosure of information relating to tax exempt organizations described in section 501 of the Internal Revenue Code of 1986.

The Joint Committee on Taxation issued the results of its study in three volumes.[50] The Treasury Department, Office of Tax Policy issued the results of its study in one volume.[51] These studies constitute a significant historical and policy-based analysis of tax information confidentiality and its importance to the proper functioning of the U.S. tax system.

Both studies addressed Congress' directives and offered general and specific recommendations. The following discussion briefly describes the studies' recommendations about major issues.

- Treasury generally recommended that Congress not make any significant policy and structural changes to Section 6103, and instead offered resolutions to specific issues.
- In evaluating specific proposals for additional governmental disclosures, Treasury recommended that the Federal, State, or local agency requesting the information make the case for disclosure, including providing assurances that the information will be properly protected. Apparently, Treasury often found itself in a defensive position of having to justify why it should not provide access to the requested data prior to receiving adequate demonstration of why it should.[52]
- More importantly, Treasury stated that it is necessary to apply specific criteria in a consistent manner in evaluating legislative proposals for additional disclosures. Treasury and the IRS have been using a list of criteria to evaluate legislative proposals. Treasury's proposed list includes nine questions to be addressed by the

[50] Staff of the Joint Committee on Taxation, Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring And Reform Act of 1998, Vol. I: Study of General Disclosure Provisions, Vol. II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations, Vol. III: Public Comments and General Accounting Office Reports (JCS-1-00), January 28, 2000.

[51] Department of Treasury, *Report to The Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions, Vol. I: Study of General Provisions*, October 2000. This report addressed five of the directives mentioned above. The sixth item Congress directed Treasury to examine (greater disclosure of information related to tax-exempt organizations) was to be addressed in Volume II of the report and published separately.

[52] See Treasury Report, supra note 1, at 67-68.

requester, the requester and Treasury/IRS, and Treasury/IRS.[53] A more extensive set of criteria for disclosure for non-tax purposes was developed by the IRS in 1994 and is attached to the report as Appendix A.

- The Joint Committee on Taxation recommended that new access to returns and return information should not be provided unless the requesting agency can establish a compelling need for the disclosure that clearly outweighs the privacy interest of the taxpayer. Further, all provisions authorizing disclosure of returns and return information should be contained in the Internal Revenue Code. The Joint Committee also recommended that Congress not expand contractor access to return information.

In April 2000, the House of Representatives passed H.R. 4163, Taxpayer Bill of Rights 2000 (TBOR 2000). This bill addressed several of the issues included in the studies by the Joint Committee on Taxation and the Treasury Department. More recently, the House passed H.R. 1528, Taxpayer Protection and Accountability Act of 2003, which addresses issues included in the Joint Committee and Treasury Studies. A companion bill, S. 882, Tax Administration Good Government Act, has been introduced in the Senate.

REASONS FOR CHANGE

In the years following TRA 76, changes to IRC § 6103 have generally occurred in response to various demands by other federal agencies for access to, or more liberal use of, tax information.[54] In addition to the increasing demand by federal and state agencies for tax information, non-governmental parties such as mortgage and other lenders now routinely obtain copies or transcripts of applicants' returns, pursuant to the applicants' consent, in order to verify income.

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[53] Id. at 68-69. Following is a list of criteria Treasury and IRS have applied:

Criteria to be addressed by the requester:

1. Is the requested information highly relevant to the program for which it is to be disclosed?
2. Are there substantial program benefits to be derived from the requested information?
3. Is the request narrowly tailored to the information actually necessary for the program?
4. Is the same information reasonably available from another source?

Criteria to be addressed by the requester and Treasury/IRS:

5. Will the disclosure involve significant resource demands on IRS?
6. Will the information continue to be treated confidentially within the agency to which it is disclosed, pursuant to standards prescribed by the IRS?
7. Other than section 6103, are there any statutory impediments to implementation of the proposal?

Criteria to be addressed by Treasury/IRS:

8. Will the disclosure have an adverse impact on tax compliance or tax administration?
9. Will the disclosure implicate other sensitive privacy concerns?

[54] The Medicare Bill, Pub. L. No. 108-173 §§ 105(e) and 811(c), 117 Stat. 2006 (2003). This bill contains two new disclosure provisions that have been codified at IRC §§ 6103(1)(19) and (1)(20). Section 105(e) provides for disclosure of return information to Department of Health and Human Services for purposes of providing transitional assistance under the Medicare Discount Card Program. Section 811(c) provides for disclosure of return information to Social Security to carry out Medicare part b premium subsidy adjustment.

Taxpayer consents to disclosure of tax information create numerous policy and administrative problems. First, the consents are not truly voluntary. Students cannot obtain certain education loans and homebuyers often cannot obtain a mortgage unless they provide their consent for disclosure. Second, most statutory exceptions spell out specifically the items of tax information to be disclosed, to whom, and for what purpose; consensual grants typically are written broadly. Third, systemic consents, whether the requester is a government agency or a private third party, are not subject to the use limitations or safeguards contained in other statutory exceptions. Fourth, the Code's civil or criminal sanctions are not available where the requester has disclosed or used the information in a manner inconsistent with the purpose for which consent was given.

More recently, the terrorist attacks of September 11, 2001, have caused Congress to review the limitations on sharing tax information with law enforcement and intelligence agencies.

Each exception to IRC § 6103 – whether it involves obtaining an updated address for child support arrears collection, or verifying gross income for purposes of a student loan or Medicaid application – whittles away at the core promise of the voluntary tax system:

> If you come forward and file this highly personal information with us, we will hold this information in confidence.

Any exception, then, must be subjected to strict scrutiny.

Disclosure to Agencies for Non-tax Criminal Cases

In 1976, Congress significantly altered the rules governing the availability of tax information to Federal agencies for purposes of nontax criminal cases. At that time, this information was freely available to the Department of Justice for law enforcement purposes. The Senate Finance Committee report provided the following rationale:

> The committee decided that the information that the American citizen is compelled by our tax laws to disclose to the Internal Revenue Service was entitled to essentially the same degree of privacy as those private papers maintained in his home. Present law and practice does not afford him that protection – the Justice Department and other Federal agencies, as a practical matter, being able to obtain that information for nontax purposes almost at their sole discretion.[55]

To address these concerns, Section 6103(i) provides that during the course of Federal nontax criminal investigations,

- Federal agencies must obtain an *ex parte* order from a Federal district judge or magistrate in order to gain access to tax returns and tax information provided by the taxpayer or the taxpayer's representative.[56]

[55] S. Rep. No. 94-938, supra note 39, at 328.

[56] IRC § 6103(i)(1).

- The IRS may disclose return information reported by third parties if the head of the Federal agency (or other specified official) submits a written request.[57]
- Where the IRS has evidence of a Federal nontax crime and such evidence is not on a tax return and is not tax information provided by the taxpayer or the taxpayer's representative, the IRS can disclose this information to the appropriate head of agency on its own initiative.[58]

In order to disclose information obtained under IRC § 6103(i) during the course of a criminal trial, the court must find that the information is probative of a matter relating to the commission of the crime or a party's guilt or liability.[59]

During the deliberations leading to the enactment of the USA Patriot Act,[60] Congress considered two related bills containing language to amend Section 6103 to permit disclosure of returns and return information to any agency for purposed of fighting terrorism.[61] Ultimately, Congress enacted the Victims of Terrorism Tax Relief Act of 2001,[62] which amended IRC §6103(i) to permit the Secretary of the Treasury to share return information (that is not taxpayer-supplied) with federal law enforcement agencies investigating terrorism. In turn, these Federal recipients may share the return information with State and local law enforcement agencies that are part of their anti-terrorism response or investigative teams.[63] The language the Administration initially proposed essentially permitted the sharing of any and all tax information with federal law enforcement and intelligence agencies including State and local agencies involved in anti-terrorism activities. The actual language enacted is narrower. The original Patriot Act proposals contained no court order mechanism, no written request mechanism, no standards other than "to assist" in the responses to terrorism, investigations of terrorism, and in the collection and analysis of intelligence and counter-intelligence information concerning terrorism. The Patriot Act language did not distinguish returns from return information (not supplied by

[57] IRC § 6103(i)(2).

[58] IRC § 6103(i)(3)(A).

[59] IRC § 6103(i)(4). The Senate Report for TRA 76 addressed this issue:
Once the Justice Department or any Federal agency has received returns (or parts thereof) or return information pursuant to the court order procedure, further disclosure in an administrative hearing or trial relating to the violation of the nontax criminal law would not be allowed unless there is a showing to the presiding hearing officer or judge that such return information is probative of the commission of the crime. Thus, a return (or parts thereof) or return information would not be admissible for purposes of "collateral impeachment", i.e., discrediting a witness on matters not bearing upon the question of the guilt of the defendant. S. Rep. No. 94-938, supra note 39, at 329.

[60] 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. The Act contains a number of provisions aimed at preventing and punishing terrorist acts domestically and internationally. It includes procedural adjustments designed to facilitate criminal investigations such as easing government access to confidential information, but makes no specific reference to tax information and/or IRC § 6103.

[61] H.R. 2975 107th Congress (2001) and S. 1510 (anti-Terrorism Act of 2001), 107th Congress, 2001

[62] Pub. L. No. 107-134 (January 23, 2002).

[63] Pub. L. No. 107-134, § 201. IRC § 6103(i)(7).

the taxpayer). What Congress did, in response, after the provisions were pulled from the Patriot Act, was to draw from the language of the existing IRC §6103(i) nontax criminal disclosure provisions and apply them to the terrorism related disclosures that became the Victims of Terrorism Tax Relief Act of 2001.[64]

The expansion of the availability of tax information to tens of thousands of state and local law enforcement agencies, even with the limitation to investigations of terrorism, raises serious tax administration concerns. It is simply not possible for the IRS to monitor the use of this information and ensure that each agency with access to this information has the appropriate safeguards in place. Indeed, Treasury noted in its report that

> . . . with regard to disclosures for state and local law enforcement purposes, it was noted by former Commissioner Kurtz in 1981 that there were 19,000 state and local law enforcement agencies in the United States, and that many of those agencies did not have the 'minimum ability to safeguard [tax] information.' The same concerns exist today.[65]

Disclosure to Agencies for Civil Nontax Purposes

One of Congress' major concerns during the 1976 overhaul of the disclosure rules was the widespread use of tax information by Federal and state agencies for nontax administrative purposes.

> It has been stated that the IRS probably has more information about more people than any other agency in this country. Consequently, almost every other agency that has a need for information about U.S. citizens, therefore, logically seeks it from the IRS.
>
> Questions have been raised and substantial controversy created as to whether the present extent of actual and potential disclosure of return and return information to other Federal and State agencies for nontax purposes breaches a reasonable expectation of privacy on the part of the American citizen with respect to such information. This, in turn, has raised the question of whether the public's reaction to this possible abuse of privacy would seriously impair the effectiveness of our country's very successful voluntary assessment system, which is the mainstay of the Federal tax system.[66]

Federal and state agency pressure on the IRS and Treasury for access to this information has only increased since 1976. Much of this pressure has come in the context of studies and reports demonstrating that the efficiency and efficacy of Federal programs, particu-

[64] The disclosure provisions of the Victims of Terrorism Tax Relief Act of 2001 expired on December 31, 2003. At the time of printing this report, Congress has not yet acted on extension of the disclosure provisions.

[65] Treasury Report, *supra* note 1, at 64-65.

[66] S. Rep. No. 94-938, *supra* note 39, at 318.

larly in the area of Federal benefit programs, would be significantly improved if federal information systems, including those holding tax information, were coordinated and linked in some fashion.[67] In fact, legislation has been proposed granting access to tax information to Federal agencies that administer any Federal benefit program.[68]

The same technological revolution that enables the Federal government to collect and share data has also contributed to the growth of an entire private sector industry specializing in consumer and other personal information. Indeed, the IRS itself utilizes private databases in order to locate taxpayers or locate and value assets. Moreover, the IRS buttresses its own address information with the United States Postal Service change of address database.[69]

The National Taxpayer Advocate acknowledges the need for efficiency and effectiveness in government programs, and the value of tax information as a current source of information about participants in other agency programs. Nevertheless, widespread access to and use of tax information by Federal or State agencies will, in fact, undermine our tax administration system. As Treasury has stated, "if IRS data is to be provided at all, the IRS should be the last stop – not the first – for information for purposes unrelated to tax administration."[70] Thus, Federal agencies should demonstrate that other government or private sector databases cannot meet their needs before seeking access to tax information.

IRS estimates that a change in tax compliance of even one percentage point equates to an annual loss of over $20 billion of revenue to the Federal government.[71] Given that taxes are the lifeblood of government – that is, government will be unable to fund its programs and services without tax revenue – it may be foolhardy to seek increased Federal efficiency at the expense of taxpayer privacy and tax compliance.

Consent-based Disclosures: IRC § 6103(c)

Internal Revenue Code section 6103(c) authorizes the Secretary to disclose, pursuant to regulations, tax information to any person designated by the taxpayer.[72] This information, however, shall not be disclosed if the Secretary determines that "such disclosures would seriously impair Federal tax administration."[73]

[67] *See* Treasury Report, *supra* note 1, at 67 for a discussion of these initiatives.

[68] Federal Benefit Verification and Integrity, H.R. 2347, 105th Cong. (1997).

[69] In fact, taxpayers may be more willing to inform the US Postal Service of address changes since it is not an enforcement agency.

[70] Treasury Report, supra note 1, at 34.

[71] IRS NHQ Office of Research, TAX GAP MAP for Tax Year 2001, (July 2003).

[72] Under the regulations, the taxpayer designates the party to whom his tax information should be disclosed by completing a request for or consent to disclosure, usually on Form 4506, Request for Copy or Transcript of Tax Form or Form 8821, Tax Information Authorization. The regulations provide for nonwritten (oral) consents only in the tax context. Thus, the consents used for benefit programs and mortgages still must be in writing. Under the regulations, electronic consents are deemed "written." See Treas. Reg. 301.6103(c)-1.

[73] IRC § 6103(c).

Consent-based disclosures raise significant privacy concerns. First, consent-based disclosures significantly undermine the general privacy protections of IRC § 6103 because there is no limit to the number and kind of businesses and individuals who may require consent as a condition of providing a good or service.[74] Second, consent-based disclosures are not subject to use restrictions, i.e., limitations on to whom and for what purposes specific pieces of tax information can be shared or re-disclosed. Moreover, these disclosures are not subject to any of the statutory safeguards in place under IRC § 6103(p). Thus, the IRS is not required to maintain a record or keep an accounting of disclosures made under IRC § 6103(c) or make reports on such disclosures to the Joint Committee on Taxation.

Private Sector Use of Consents

One of the most common uses of consents in the private sector is for verification of a mortgage applicant's financial information that forms a basis for granting the loan. Quite frequently, an investor other than the mortgage originator will ultimately purchase the loan and provide loan funding. In this case, the re-investor will conduct its own financial investigation of the debtor.

These financial arrangements have led to an industry practice in which taxpayers applying for and obtaining mortgage loans are asked to sign a Form 4506, Request for Copy or Transcript of Tax Form, at the time of closing. With respect to the Form 4506 presented at closing, the taxpayer is often asked to sign without filling in the name of the party to whom information will be disclosed, and without dating the consent.[75] This practice enables the lender to sell the loan in the secondary market, where a prospective buyer may want to verify income of the mortgagee at that time.[76]

Section 6103(c) does not limit the use of tax information obtained by consent to the original purpose for which it was obtained. Thus, tax information obtained by a mortgage institution or other investor pursuant to a section 6103(c) consent could be used by that entity or person for purposes other than verifying the loan applicant's financial information.

[74] Citing legislative history, one court barred the IRS from releasing tax information pursuant to certain consent forms solicited by the Social Security Administration. See Tierney v. Schweiker, 718 F.2d 449 (D.C. Cir. 1983), discussed in note 79 infra. However, the court's decision applied only to requests initiated by government agencies – not private actors – and it expressly stated that its holding as to government agencies was limited to the specifics of the consent form in issue in the case. Id. at 456.

[75] The 6103(c) regs require the IRS to receive the consent within 60 days of its execution (presumably when signed and dated). It is valid until revoked. As a practical matter, however, consents designed for "single use" are only used in that manner (and are not saved or entered into systems to permit reliance at a later time). Exactly how long consents are maintained varies by program (generally, the RAIVS units in campuses, which process Forms 4506, hold onto them for only six months).

[76] The National Taxpayer Advocate has received numerous reports that taxpayers have been placed in the situation of coerced consents – either sign the incomplete Form 4506 or not proceed with closing. For an example of coerced consents by a government agency, see Tierney v. Schweiker, 718 F.2d 449 (D.C. Cir. 1983), discussed in note 79 infra. The Joint Committee on Taxation notes that "[t]he coerced consents obtained in financial transactions from taxpayers (lenders won't make loans without verification of income) differ little from the consents invalidated in the Tierney case." JCT Study, supra note 1, at 228.

The problems associated with private sector use of consents will only increase with any widespread implementation of the Service's Electronic Transcript Delivery System (ETDS). Under this program, consents can be transmitted to the IRS with electronic signatures. The IRS can then deliver transcripts, limited to the specific items requested, to the requester in a minimal period of time.

While this system has many benefits – the shorter turnaround time, limited access to information, elimination of the practice of incomplete, and undated consents – there are also serious dangers. Of greatest concern is the fact that ETDS creates the capacity for widespread use of taxpayer data obtained by "consent", such that, as Treasury notes, "every taxpayer can expect his/her return information to be disclosed by the IRS for some purpose, i.e., the consent exception will swallow the rule of confidentiality."[77]

In response to these concerns, the IRS has retreated from its proposed plan to make this service widely available to the private sector. The IRS will pilot the program in the Atlanta area, and it will be made available only to tax professionals who e-file 100 or more accepted individual tax returns.[78]

Government Agency Use of Consents

In 1976, Congress was specifically concerned about the widespread use and sharing of tax information among government agencies. In TRA 76 and the years following, Congress attempted to limit any exceptions to confidentiality to those instances where it had determined that the third party's need for the information outweighed the taxpayer's privacy interest and tax administration concerns.

From time to time, government agencies have sought to avoid the lengthy and difficult process of obtaining a legislative exception to IRC § 6103's general rule of confidentiality by conditioning the availability of government benefits on a beneficiary's willingness to consent to the release of tax information to that agency (or its contractors). The National Taxpayer Advocate believes that these procedures may, over time, vitiate the concept of a voluntary consent.[79]

[77] Treasury Report, *supra* note 1, at 72.

[78] The National Taxpayer Advocate notes that limiting this program to tax preparers who e-file large numbers of tax returns actually does not place transcripts quickly in the hands of tax representatives who need them. That is, many representatives who actually assist taxpayers with tax disputes requiring transcripts – audits, audit reconsideration, collection alternatives including Collection Due Process hearings, Offer-in-Compromise, Installment Agreements, Bankruptcy, Tax Court, and refund claims – are not electronic return originators or do not otherwise file 100 or more individual returns.

[79] In Tierney v. Schweiker, *supra* notes 74 & 76, the Social Security Administration (SSA), in an effort to reduce fraud in its Supplemental Security Income (SSI) program and following a GAO study and recommendation, asked 4 million former and current SSI recipients to sign a consent form that authorized SSA to receive tax information from the IRS. The SSA letters stated: "You have a choice about signing the [consent] form. But we must have accurate information about your income and what you own to pay your Supplemental Security Income checks. If you do not sign the form, your Supplemental Security Income checks may be affected." Id. at 452.

The systemic use of consents is particularly troublesome because more federal agencies are now using contractors to perform services. As noted earlier, IRC § 6103(c) does not now contain protections for limiting the use of information or to whom it can be disclosed, nor does it require the IRS to report on such disclosures to the Joint Committee on Taxation. Moreover, Federal agencies receiving tax information pursuant to taxpayer consents are not subject to safeguard requirements of IRC § 6103(p)(4). It is possible that, if such requirements were imposed, agencies might find other, less burdensome ways to obtain the needed or substantially similar information.

Agency Contractors and Confidentiality of Return Information

The Federal government's increasing use of contractors to perform its nongovernmental functions has led to the increased use of consents to obtain tax information. Even in those instances where an agency has statutory authority to receive tax returns or return information, consents may be necessary where the statute does not specifically authorize re-disclosure to contractors or agents.[80]

The National Taxpayer Advocate recognizes this trend in government services, as well as agencies' use of computer, housekeeping, and mail service contractors that might have access to tax information. She joins the Joint Committee in Taxation, however, in its concern that "expanding the number of persons who have access to returns and return information increases the likelihood that confidential information will be unlawfully disclosed."[81]

EXPLANATION OF RECOMMENDATIONS

Confidentiality and Disclosure in General

The National Taxpayer Advocate recommends that IRC § 6103 be amended to direct the Secretary of the Treasury to develop prescribed criteria that any future legislative exceptions to the general privacy protections of IRC § 6103 must satisfy. The IRS and Treasury have long used a list of questions that any requester of tax information must answer in

SSA offices were directed that refusal to sign the consent form was, in itself, grounds for suspension of benefits. SSA offices were also instructed to use the following language in letters notifying SSI recipients of suspension of benefits: "Since you have not signed the authorization form we can not determine if you continue to be eligible for Supplemental Security Income payments. Therefore, we can not pay you any more benefits beginning month/year." Id. at 453.

The court observed, in light of section 6103's legislative history, that "the IRS cannot use the consent exception of subsection 6103(c) as a 'catch all' provision to circumvent the general rule of confidentiality established by Congress." Id. at 456. It further noted that the SSA "consent" form contained "poorly-veiled threats" of cessation of benefits, and was "thus likely to coerce individuals, who depend on social security for their subsistence, into giving up their right to confidentiality." Id. After noting, indicta, the coercive nature of the consents, the court held that the Social Security form, signed by almost 3 million taxpayers, did not satisfy the separate written document requirement in the regulations under section 6103(c) and accordingly were invalid.

[80] See Treasury Report, *supra* note 1, at 78 – 82 for a discussion of disclosure issues with respect to IRC § 6103(l)(6) and disclosures to state and local child support enforcement agencies.

[81] JCT Study, *supra* note 1, at 219.

order to justify proposed access. The statute should clearly state than any exceptions to the confidentiality of tax information will be granted only in those rare circumstances where an agency can demonstrate that its compelling need for that information outweighs both the taxpayer's privacy interests and the impact of disclosure on voluntary tax compliance.

The legislative history of IRC § 6103 should make clear that where, as a matter of policy or if the need for the information outweighs the taxpayer's privacy interests and the impact on tax administration, disclosure is warranted, such disclosure should be limited to the least amount of information necessary to achieve the agency's purpose. Where that purpose can be achieved through a "fact of ….(filing/discrepancy/balance due)" acknowledgement, the disclosure should be so limited.

Disclosure to Law Enforcement Agencies

The National Taxpayer Advocate recognizes the compelling policy considerations in the areas of national security and terrorist activity. Such concerns motivated Congress to override its stated concerns about widespread access to returns and return information by law enforcement agencies. These considerations do not, however, diminish the very real danger that this expansion, without proper oversight, may significantly erode taxpayer privacy. As Treasury has noted in another context, the IRS does not have the resources to monitor the access to or use of tax information by the tens of thousands of State and local agencies.

Thus, we urge Congress, prior to re-enactment of the provisions in the Victims of Terrorism Tax Relief Act, to request the General Accounting Office to study the effectiveness of the safeguards for these disclosures and of the IRS' oversight of the implementation of this provision. A similar study should be conducted in five years from the date of re-enactment, if any, to determine the long-term impact of such disclosures on the privacy interests of taxpayers.

Disclosure Pursuant to Taxpayer Consent

The National Taxpayer Advocate is concerned about the increasing tendency of agencies and the private sector to seek tax information through the use of consents. Thus, she recommends that IRC § 6103(c) be amended, with respect to all third parties (government and private sector), to limit the disclosure of returns and return information requested pursuant to a consent to only the extent necessary to achieve that purpose and to only the use for which it was requested.[82]

[82] Section 406 of H.R. 1528, Taxpayer Protection and IRS Accountability Act of 2003, passed by the House on June 19, 2003, prohibits re-disclosure by third party designees. Under the bill, a consent will only be valid for purposes of IRC § 6103(c) if, at the time of execution, the consent designates a recipient and is dated, and at the time such consent is submitted, the submitter certifies under penalties of perjury that the consent was complete. Finally, the bill would require the Secretary to provide a prominent warning on the consent form that the taxpayer not sign the consent if it is incomplete and to direct taxpayers that if they feel coerced in signing the incomplete or blank form, they should report the incident to Treasury Inspector General for Tax Administration. A similar provision is included in S. 882, Tax Administration Good Government Act, introduced on April 10, 2003. The National Taxpayer Advocate supports this approach.

Further, Internal Revenue Code sections 7213 and 7431 should be amended to apply criminal and civil sanctions, respectively, for wrongful disclosure and inspection by third parties who receive returns and return information pursuant to an IRC § 6103(c) consent, where such information is used in a manner inconsistent with that consent.

The National Taxpayer Advocate recommends that the IRS revise Forms 4506, Request for Copy or Transcript of Tax Form and 8821, Tax Information Authorization, and their instructions, to clearly state a consumer-type warning about taxpayer privacy rights, the re-disclosure and use provisions, the danger of signing undated or incomplete consents, and the remedies available to the taxpayer for violations of disclosure provisions. Further, the IRS should develop a brochure designed to help taxpayers know their privacy rights.

Section 6103(p)(3)(C) should be amended to require the Secretary to include in his or her annual disclosure report to the Joint Committee on Taxation detailed information on the number and types of disclosures pursuant to taxpayer consent. The report should describe whether such requests were electronic, paper-based, or oral, and whether such requests were submitted by agencies, contractors, or the private sector, along with the number of requests per type of requestor.

Disclosures to Government Agencies

It is anticipated that government agencies will only need consents in rare, non-systemic instances. A systemic-based use of taxpayer consents should only be proposed by a government agency in conjunction with a pilot that must be conducted prior to developing a request for creating a statutory exception under IRC § 6103.[83] If the agency uses contractors as part of the pilot, the taxpayer must be provided notice of and specifically consent to the disclosure of tax information to the agency's contractors. Any statutory request based on that pilot must specifically address the release of information to contractors (including use, extent, and purpose). Further, government agencies that propose pilots utilizing taxpayer consents must be subject to the same safeguards under IRC § 6103(p)(4) as are disclosures under statutory exceptions.

As with the private sector, Federal agencies should not be able to use consents to create a work-around to the more stringent statute-based exceptions under IRC § 6103. Thus, while agencies should be able to conduct a pilot using consents to demonstrate the accuracy of their initial assertions of need and minimal privacy and tax administration impact, the tax-writing committees of Congress should submit the results of the pilot to strict scrutiny. If the proposal cannot survive such scrutiny, it should not be expanded through consent.

[83] This proposal should only be implemented in conjunction with an amendment to provide restrictions on the use of tax information disclosed under consents, and the applicability of penalties for wrongful use.

By proposing that government agencies be generally required to conduct a pilot program prior to obtaining a statutory exception to IRC § 6103, the National Taxpayer Advocate recognizes that in some instances – e.g. with anti-terrorism disclosures – the agency will not be able to obtain taxpayer consents. Thus, it is anticipated that there will be instances for which a pilot program is neither feasible not appropriate. In these cases, Congress should consider the use of a sunset date, which would necessitate a review of the program and its impact on taxpayer privacy and tax compliance.

Disclosure to Contractors

The disclosure of tax returns and tax return information to Federal or other agency contractors should not be permitted unless specifically authorized in a statutory exception.[84] Given the IRS' limited resources for monitoring these arrangements, programs should be designed so as to eliminate the need for contractors to have access to tax information released to the agency. Only in the most compelling circumstances should contractors have access to tax information, and in those cases access should be limited to items such as a taxpayer's address, or "fact of …." or match/mismatch acknowledgements. Where such narrow disclosure proves unworkable and renders the program ineffective, then the disclosure of tax information should be limited to the minimum number of nontax administration contractors over which the IRS can provide meaningful oversight and safeguards.

As noted above, taxpayers should be provided with notice and specifically agree that, in the course of a consent-based pilot, the agency may re-disclose tax information to contractors. All codified exceptions to confidentiality must specifically state whether contractors or agents will be used. During pilots and in statutory disclosures, agencies and their contractors must be subject to the safeguard provisions of IRC § 6103(p)(4), and agencies and their contractors or agents must be subject to the civil and criminal sanctions of IRC §§ 7213, 7213A, and 7341.

Periodic Review of Impact on Tax Administration

It is possible that even with the most careful testing and implementation, a pilot or statutory exception's impact on voluntary tax compliance or taxpayer privacy rights will not surface for several years. To this end, the National Taxpayer Advocate recommends that before any proposed disclosure proposal is enacted, its pilot be conducted over a number of tax years, to determine the short-term effect on voluntary tax compliance. Further, upon enactment of a new exception to IRC § 6103, Congress should establish a "sunset" date five years hence. Prior to re-enactment of the provision, Congress should require the Secretary of the Treasury to study and report on the impact, if any, of the disclosures on

[84] But see discussion of agency pilot programs using consents supra.

taxpayer privacy and voluntary tax compliance, and make recommendations to mitigate or eliminate that impact.

Finally, in order to insure against "disclosure creep", Congress should periodically – every ten years – direct the Secretary of the Treasury to review each statutory disclosure exception to IRC § 6103 and report and make recommendations to the Joint Committee on Taxation about

- whether the compelling needs it was designed to meet are still present;
- whether technology or private sector improvements have reduced the agency's need for tax information (that is, the information can now be obtained from another source); and
- whether safeguard and penalty provisions are sufficient to protect taxpayer and tax administration's interest in maintaining the confidentiality of tax returns and return information.

2 TAX WITHHOLDING ON NON-WAGE WORKERS

The issue of how a worker is classified – as employee or independent contractor – has consequences for both the worker and the recipient of services. Many small businesses view the obligations that arise from treating workers as employees (Social Security, Medicare, federal and state tax withholding requirements, unemployment insurance, employee benefits) as overly burdensome. These businesses may treat workers who are technically employees as independent contractors, thereby not withholding taxes on payments to them. Where a worker or the IRS successfully challenges these classifications, the business can incur significant additional tax, penalties, and interest.

On the other hand, many non-employee workers, including independent contractors, discover an unwelcome "April 15th surprise" when the time comes to file their federal income tax returns. While they may wish to comply with filing requirements, they have a substantial tax bill to pay because no federal income tax or Federal Insurance Contributions Act (FICA) tax was withheld from their earnings.

Under current law, taxes generally are withheld over the course of the year from wages paid to workers classified as employees, but no tax is withheld from payments made to workers who are not classified as employees (i.e., independent contractors). Some workers hired as independent contractors are unaware of the tax consequences of accepting a non-employee job until they must file returns, and discover that no federal income tax has been withheld. Other workers are aware of the tax rules but do not save enough money to pay their taxes or make required quarterly estimated tax payments. Still others operate in the cash economy, in whole or in part.

The amount of unreported and underreported tax attributable to independent contractors (sole proprietors) – $81.2 billion – is the largest single component of the tax gap.[1] The absence of a withholding mechanism leads to a balance due return, which in turn leads some taxpayers to underreport their income in order to avoid the balance due. This under- or non-reporting of income imposes a burden on compliant taxpayers who pay their tax obligations in full.

Employers who treat workers as employees are disadvantaged – their competitors can undercut them because the independent contractors can avoid paying tax and charge less for their services. Thus, employers are placed in the position of having to choose between being competitive and complying with the tax laws.

[1] The tax gap is the amount of tax that is imposed by law for a given tax year but is not paid voluntarily and timely. The estimated size of the gross tax gap for tax year 2001 was $310.6 billion. Tax Gap Map for tax year 2001 from IRS National Headquarters Office of Research, July 17, 2003. *See* Most Serious Problem #2 - "Non-filing and Underreporting of Schedule C Taxpayers" for a detailed discussion of the impact of Schedule C taxpayer non-compliance on the tax gap.

EXAMPLE

Taxpayer A is a winery and employs 30 persons, 20 of whom tend the vineyards on a full-time basis. Taxpayer A controls the details and manner by which these workers care for the vines and produce the wine. The workers are required to follow detailed instructions and use the winery's equipment in discharging their duties. Taxpayer A, following the advice of its tax advisor, treats these workers as employees and withholds the appropriate tax amounts from their paychecks. The winery also pays federal and state unemployment taxes and worker's compensation. It factors the cost of payroll and related taxes and insurance into the price of its wine.

A neighboring winery, Taxpayer B, is of similar size and also employs 30 persons, over whom Taxpayer B has a similar degree and type of control. Taxpayer B also produces a similar wine to Taxpayer A's. Taxpayer B, however, is able to underprice Taxpayer A's wine because Taxpayer B treats its workers as independent contractors. Thus, Taxpayer B does not incur the employer share of FICA tax, unemployment tax, or other payroll-related costs.

Taxpayer A's employees have their taxes withheld from their checks so they generally will not owe taxes by year-end. They are also earning credits toward Social Security and Medicare coverage. Taxpayer B's workers, on the other hand, are responsible for paying their own self-employment tax as well as their income tax. Because they are minimum wage workers, many of them cannot save and pay estimated taxes; thus they will have balance due returns and accrue penalty and interest. If they do not file their returns and pay taxes, they will not accrue Social Security and Medicare quarters toward coverage.

RECOMMENDATION

The National Taxpayer Advocate recommends extending a modified withholding scheme to certain payments made to independent contractors. The withholding rate would be five percent on payments to independent contractors not generally maintaining an inventory or receiving payments for materials and supplies. Further, Congress should authorize the Secretary to establish withholding rates specific to certain trades and industries that maintain inventories or receive payments for materials and supplies.[2] Where the Secretary does not establish such guidelines, the withholding rate would be 3.5 percent on payments to independent contractors that maintain inventories or receive payments for materials and supplies.

[2] The Secretary also could be authorized to enter into withholding rate agreements with specific independent contractors where they can demonstrate the appropriateness of another rate. This should be discretionary with the Secretary, since the benefits of these agreements may be outweighed by the demand on IRS resources to conduct the necessary analysis precedent to the agreement.

In order to implement this withholding regimen, The National Taxpayer Advocate makes the following legislative recommendations:

- Amend Internal Revenue Code section 3402(o)[3] to expand withholding on certain reportable payments other than wages to include:
  1. Any payment aggregating $600 or more during a calendar year made by a service recipient engaged in a trade or business to any person for services performed. The payment is required to be reported on a return under IRC § 6041A(a).[4]
  2. Any payment required to be shown on a return pursuant to IRC § 6050A relating to reporting requirements of certain fishing boat operators, but only to the extent such payment represents a share of the proceeds of the catch and is paid with money.[5] In addition, withholding would apply to cash payments of up to $100 per trip that are contingent on a minimum catch, are paid solely for additional duties for which cash payments are traditional in the industry, and are reportable on Form 1099-MISC.[6]
  3. Any payment required to be shown on a return required under IRC § 6041A relating to persons receiving contracts from federal executive agencies.
- Amend Internal Revenue Code section 3402(a) to establish the rate of withholding on certain reportable payments at five percent when the aggregate amount of payments for the calendar year reaches an amount that triggers the requirement to file Form 1099-MISC pursuant to IRC § 6041A and IRC § 6050A.
- Amend Internal Revenue Code section 3402(a) to establish the rate of withholding at 3.5 percent on payments to persons in certain trades whose 1099-MISC remuneration for services rendered includes payments when the aggregate amount of remuneration paid to any person for services rendered includes payments for parts or materials used to render the services, except as provided:
  - In the case of a person described in Proposed Regulations § 1.6041A-1(a)(2), the person may elect to enter into an agreement under IRC § 3402(p)(3)(B)[7],

[3] IRC § 3402 sets forth general requirements for income tax withholding on wages. Subsection (o) addresses the extension of the withholding requirements to certain payments other than wages.

[4] IRC § 6041A(a) sets forth requirements for the filing of information returns showing remuneration for services by the person for whom the services were performed.

[5] The aggregate amount that triggers the filing of Forms 1099-MISC is not uniform across the Internal Revenue Code. IRC § 6041A and IRC § 6050M require filing when payments aggregating $600 or more during a calendar year are made, while IRC § 6050A requires filing Form 1099MISC on any payment representing a share of the proceeds of the catch. To avoid the need to address these differences, we are recommending simply that withholding begin at the point that Form 1099MISC filing is required. If cash payments contingent on a minimum catch exceed $100 per trip, the payments are considered wages for employment *See* IRC § 3121(b)(20)(a).

[6] IRC § 3121(b)(20)(A).

[7] IRC § 3402(p)(3)(B) provides guidance for withholding if the person making and the person receiving a type of payment other than wages agree to such withholding.

by furnishing the service recipient with a statement similar to the exemption certificate describing Form W-4 (withholding exemption certificate), [8] which contains:

- A statement that the person described in Proposed Regulations § 1.6041A-1(a)(2) agrees to a withholding rate of 3.5 percent on the amount required to be reported on Form 1099-MISC; or
- A statement by the person described in Proposed Regulation § 1.6041A-1(a)(2) of the gross profit percentage[9] determined for the services provided that triggered the filing of Form 1099-MISC, and that the person agrees to a five percent withholding rate on the gross profit calculated by applying the gross profit percentage to the payments required to be reported on Form 1099-MISC; or
- A statement that the person described in Proposed Regulation § 1.6041A-1(a)(2) falls within one of the specific industries for which the Secretary has established alternative gross profit percentages and agrees to a 5 percent withholding rate on the gross profit calculated by applying the gross profit percentage to the payments required to be reported on Form 1099-MISC.

- Upon receipt of the exemption certificate, the service recipient will either withhold at the 3.5 percent or industry-specific percentage rate on the amount required to be reported on Form 1099-MISC, or apply the gross profit percentage provided to subsequent gross reportable payments, and apply the rate of withholding at five percent to the gross profit calculated for this purpose.[10]

PRESENT LAW

Worker Classification

For purposes of income tax and payroll tax withholding, workers are classified into one of four categories:

Statutory employees and statutory nonemployees. These are workers who are specifically designated in the Internal Revenue Code as employees or nonemployees for purposes of income tax and/or payroll tax withholding. For example, full-time life insurance salesmen

[8] Treas. Reg. § 31.3402(p)-1(b)(1). The information required includes language directed to employees.

[9] Gross profit is gross income minus materials and supplies. Gross profit percentage is computed by dividing gross profit by gross income.

[10] Withholding agents will apply the 5 percent withholding rate to gross profit to eliminate the withholding disparity between those service providers who supply materials and supplies as opposed to those who provide services only.

are statutory employees for purposes of FICA (spell out) and Federal Unemployment Tax Act (FUTA) taxes.[11] Home workers are statutory employees for FICA purposes.[12] Direct sellers[13] and companion home sitters[14] are examples of statutory nonemployees.

Common law employees. A worker will be classified as a common law employee for purposes of income and payroll tax withholding if an analysis of the specific facts and circumstances of the employment arrangement under common law principles indicates that the worker is subject to another's control or direction not only as to the result of the work but also as to the details and means by which the work is accomplished (i.e, how the work will be done). The employer need not actually control the manner in which the work is done – it is enough that the employer has the right to control.[15]

Independent Contractors. If the worker does not satisfy either the common law tests for employee status and is not a statutory employee under the Code, then he or she is considered an independent contractor for purposes of income and payroll tax withholding. Workers who are independent contractors must pay self-employment tax on their net earnings.[16]

Section 530 Safe Harbor workers. Generally section 530 of the Revenue Act of 1978[17] provides that, for purposes of employment tax withholding, a taxpayer does not have to treat a worker as an employee for any period after December 31, 1978 if:

- The taxpayer did not treat the worker as an employee for employment tax purposes for any period;
- The taxpayer files all required returns relating to that worker – including information returns – on a basis consistent with treating that worker as not being an employee; and
- The taxpayer has a reasonable basis for not treating that worker as an employee.[18]

Generally, the IRS uses three main categories of factors in its determination of worker status.

- Behavioral control: Does the worker receive extensive instructions on how, when and where to do the work, or what tools or equipment to use? Does the worker receive training about procedures and methods?
- Financial control: Does the worker have a significant investment in the work? Is the worker reimbursed for his expenses? Does the worker have an opportunity for profit or loss from the work?

[11] IRC § 3121(d)(3)(B).

[12] IRC § 3121(d)(3)(C).

[13] IRC § 3505

[14] IRC § 3506

[15] Treas. Reg. § 31.3401(c)-1(b).

[16] IRC § 1402(a) and (b).

[17] Pub. L. No. 95-600.

[18] Id. at sec. 530(a)(1). A taxpayer will be treated as having a reasonable basis for not treating a worker as an employee if he relies on: (a) judicial precedent or other certain other administrative rulings; (b) a past IRS audit not resulting in an employment tax assessment with respect to that worker or (c) others holding similar positions; or long-standing recognized practice in the taxpayer's industry. Id. at sec. 530(2).

- Relationship of the parties: Does the worker receive employee benefits such as insurance, pension, paid vacation and sick leave? Is there a written contract between the parties which shows the intent of the worker and the business?[19]

Consequences of Worker Classification

If a worker is classified as an employee, the employer is required to withhold income tax[20] and the employee's share of social security and Medicare taxes (FICA taxes)[21] from the employee's wages.[18] The employer must also pay unemployment taxes on those wages.[22] Further, the employer is required to issue a Form W-2, Wage and Tax Statement, to the employee, reporting gross wages and withholding amounts for the calendar year.[23] An employee can deduct unreimbursed business expenses as miscellaneous itemized deductions on his or her individual income tax return.[24]

A worker who is classified as an independent contractor is responsible for paying his or her own income tax and self-employment tax under the Self Employment Contributions Act (SECA).[25] Generally, the independent contractor computes his or her net taxable self-employment income on Form 1040, Schedule C, Sole Proprietorship Income, by deducting business expenses from business income. The business for whom the independent contractor works must furnish the worker with a Form 1099-MISC, Miscellaneous Income, on which it reports the income it paid to the independent contractor.[26]

The classification of a worker as an employee or independent contractor has consequences other than tax withholding and the deductibility of business expenses. For example, employees may be eligible for unemployment compensation or worker compensation coverage. They may also be covered by and participate in an employer's retirement or other employee benefit plans.

[19] Internal Revenue Service, *Independent Contractor or Employee*, Publication 1779 (Rev. 5-03).

[20] IRC § 3402(a)(1). For purposes of withholding from wages, an employer is defined as the person for whom an individual performs or performed any service as the employee of that person. IRC § 3401(d). Special rules apply to persons who do not have control over the payment of wages to the provider of services and to persons paying wages to nonresident alien individuals and certain other foreign entities. IRC § 3401(d)(1)-(2). Wages are defined as "all remuneration . . . for services performed by an employee for his employer." IRC § 3401(a).

[21] IRC § 3121(a). Wages are defined as "all remuneration...for services performed by an employee for his employer." IRC § 3401(a).

[22] IRC § 3301.

[23] IRC § 6051.

[24] See generally IRC §§ 162, 63(d), 67(a), 67(d).

[25] Pub. L. No. 83-591, 68A Stat. 1, 353 (Self-Employment Contributions Act of 1954).

[26] IRC § 6041A(a) requires any service recipient engaged in a trade or business to report payments of $600 or more made in a calendar year to the person providing services. The IRS 2003 Instructions for Form 1099-MISC state that payments to a corporation are generally not required to be reported on the form. The following payments to a corporate service provider, however, must be reported on Form 1099-MISC: medical and health care payments; fish purchases for cash; attorneys' fees; gross proceeds paid to an attorney; payments by a Federal executive agency for services (vendors); and substitute payments in lieu of dividends or tax-exempt interest.

Withholding on Payments Other Than Wages

Certain non-wage payments are subject to mandatory or voluntary withholding. Internal Revenue Code section 3402(o) extends mandatory withholding to certain supplemental unemployment compensation benefits to the extent that the benefits are includible in gross income.[27] Any payment of an annuity or sick pay to an individual is subject to withholding if the payee makes a request for withholding.[28] Internal Revenue Code section 3402(p)(3)(A) and (B) provide for other voluntary withholding from any other appropriate type of payment.[29]

Backup Withholding

Backup withholding on reportable payments is required under certain circumstances. These circumstances include instances when the payee does not provide a Tax Identification Number (TIN) to the payer, or the IRS notifies the payer that the TIN furnished by the payee is incorrect.[30] Payments subject to backup withholding include those made in the course of a trade or business to a person for services performed,[31] and monies paid by certain fishing boat operators,[32] which must be reported on information returns.

Federal Contractors

There is no provision in the Internal Revenue Code governing income tax withholding on federal contracts. The head of every federal executive agency that enters into certain contracts must file an information return reporting the contractor's name, address, TIN, date of contract action, amount to be paid to the contractor,[33] and any other information required by Forms 8596 (Information Return for Federal Contracts) and 8596A (Quarterly Transmittal of Information Returns for Federal Contracts) and their instructions.[34]

[27] IRC § 3402(o)(1)(A).

[28] IRC § 3402(o)(1)(B) and (C).

[29] IRC § 3402(p)(3)(B) authorizes the Secretary to prescribe regulations that provide for voluntary withholding from other types of payments if the employer and employee, or the person making and the person receiving the other type of payment, agree to the withholding. In this circumstance, the payments would be treated as if they were wages paid by an employer to an employee.

[30] Treas. Reg. § 31.3406(a)-1.

[31] IRC § 3406(b)(3)(B).

[32] IRC § 3406(b)(3)(D). IRC § 6050A requires the operator of a fishing boat on which one or more individuals perform services to report the percentage of each person's share of the catch and share of the proceeds of the catch as well as any cash paid.

[33] IRC § 6050M.

[34] No information return is required for any contract of $25,000 or less; any contract with a contractor who is acting in his or her capacity as an employee of a federal executive agency; any contract between a federal executive agency and another federal government unit; any contract with a foreign government; any contract with a state or local government unit; any contract with a person who is not required to have a TIN; any contract whose terms provide that all amounts will be paid on or before the 120th day following the date of the contract action; any contract under which all money (or other property) that will be received by the contractor after the 120th day after the date of the contract action will come from persons other than a federal executive agency or an agent of such an agency (e.g., a contract under which the contractor will collect amounts owed to a federal executive agency by the agency's debtor and will remit to the agency the money collected less an amount that serves as the contractor's consideration under the contract); or any contract for which the IRS determines that information described in Treas. Reg. § 1.6050M-1 will not facilitate the collection of federal tax liabilities because of the manner, method, or timing of payment by the agency under that contract. IRC § 6050A; Treas. Reg. § 1.6050M-1(c)(1).

Government agencies must report on Form 8596 the date the Federal contract was awarded and the aggregate amount of the contract (even where payments will span several years).[35]

As noted above, IRC § 6041A(a) requires a service recipient to file an information return reporting payments of $600 or more to a person for services performed. Section 6041A(d)(1) provides that a governmental unit is a person for purposes of that section, and IRC § 6041A(d)(3)(A) requires the filing of a return for payments made to a corporation by a government agency. Thus, in addition to filing Form 8596 reporting information about the contract award, government agencies must also file Form 1099-MISC reporting payments to individuals and corporations.[36]

REASONS FOR CHANGE

The absence of a withholding mechanism on payments made to non-wage workers creates several significant problems: (1) it contributes to the substantial known tax gap for independent contractors; (2) it leads some businesses to incorrectly classify workers as independent contractors, which places employers who correctly classify their workers as employees at a competitive disadvantage, and forces the IRS and taxpayers to become mired in protracted worker classification audits and determinations; (3) it harms those non-wage workers who want to comply with the law but are fearful of filing because of a large balance due amount; and (4) it harms all compliant taxpayers because they pay their correct tax liability while others do not.

From the standpoint of the tax system, the lack of a withholding mechanism leads to substantial underpayments of tax each year by some taxpayers, while compliant taxpayers pay the full amount of tax due. This disparate treatment undermines the respect of law-abiding taxpayers for the fairness of the tax system.

For employers and other service recipients, the conundrum of worker classification and the multitude of reporting and payment requirements associated with employees can drive an employer to treat employees as independent contractors. Imposing a simple, flat-rate withholding requirement on independent contractor payments levels the playing field between businesses that are currently bearing the cost of complying with the law and those who are shifting that cost to others.

[35] IRC § 6050M.

[36] Prop. Reg. § 1.6041(d) lists exceptions to return requirements if a return is required under another section. IRC § 6050M is not listed as one of the exceptions. The IRS does not have the data on whether Federal agencies filing form 8506 on Federal contractors also file the required Form 1099-MISC reporting payments to those contractors.

From the standpoint of the worker, the main reason for instituting withholding is to avoid what we have termed the "April 15th surprise" and its downstream consequences. As the filing deadline approaches, many non-wage workers realize that no tax was withheld and the entire tax liability for the year will be due at one time. In some instances, taxpayers will face large tax liabilities that they did not budget for and cannot pay. In other cases, taxpayers knew that a large amount would be due and never intended to pay more than a nominal portion of tax, if any. Still others may assume they will face large tax liabilities, but due to their income levels and family circumstances, may actually be due a refund.

Workers who owe tax and do not file, regardless of their underlying motivation, pay no Social Security or Medicare taxes and therefore do not receive credit toward Social Security or Medicare benefits. Taxpayers who owe tax will also face penalties and interest charges that will continue to accrue on both the unpaid tax and the penalties. Taxpayers who are owed a refund simply will not receive it. Moreover, the IRS must divert its limited compliance resources to addressing these problems.

By contrast, workers who are classified as employees generally do not face these consequences because the withholding mechanism sharply reduces the likelihood of large, unpaid tax liabilities at the end of the year. A withholding mechanism applicable to non-wage workers would provide similar benefits for them.

Tax Compliance and Non-employee Payments

The General Accounting Office (GAO) has identified the absence of withholding on certain non-employee payments as a problem for many years. As long ago as 1979, GAO determined that the problem of compliance among independent contractors and self-employed individuals was serious enough to recommend withholding to collect part of the tax this group owed.[37] Again in 1992, GAO reported to Congress on "Approaches for Improving Independent Contractor Compliance," recommending withholding on payments to independent contractors. The report describes withholding as "the cornerstone of our tax compliance system for employees . . . . It provides a gradual and systematic method to pay taxes and insures credit for social security coverage."[38]

In another report discussing tax gap strategies in May 1994, GAO recommended that "Congress consider requiring tax withholding on payments made to independent contractors."[39] Panelists at a 1995 GAO-sponsored Tax Gap Symposium recommended

[37] Statement of Richard L. Fogel, Associate Director, General Government Division, GAO, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, on Compliance Problems of Independent Contractors, GAO #109909, July 17, 1979, p. 7.

[38] GAO Report to Congressional Requesters, *Tax Administration, Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108, July 1992, p. 4.

[39] General Accounting Office, *Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123, May 11, 1994, p. 37.

mandatory withholding for non-wage earners. The panelists offered withholding as an alternative to clarifying the definition of independent contractor, noting that the right balance between levels of compliance and levels of tax system intrusiveness would have to be determined.[40]

The IRS National Headquarters Office of Research periodically prepares estimates of the amount of tax liability for a particular tax year that is not voluntarily and timely paid. This amount is often referred to as the "tax gap." The income tax gap consists of three main components: non-filing, underreporting, and underpayment.[41] From 1992 to 1998, the income tax gap grew an estimated 61 percent to $207 billion.[42] Of that amount, an estimated $132.5 billion – well over half – represents underreported sole proprietorship (Schedules C & F) returns that were or should have been filed.[43] This portion of the tax gap is partly but not entirely attributable to recipients of Forms 1099-MISC (Miscellaneous Income).[44]

Non-filer estimates for tax year 2000 indicate:

- There were 9,062,194 non-filers.
- 2,002,678 of those non-filers received Forms 1099-MISC (NEC).
- $48,174,172,032 in total unreported income was attributable to income of nonfilers that was reported on Forms 1099-MISC (NEC).[45]

IRS research indicates that the problems associated with non-employee filing and reporting compliance are far-reaching. The GAO has noted that "tax reporting compliance for wage earners with withholding is approximately 99 percent, while tax compliance for individuals with income not subject to withholding is significantly less. In the case of self-employed taxpayers, IRS estimates that compliance is about 41 percent."[46]

[40] GAO Report to the Joint Committee on Taxation, U.S. Congress, *Reducing the Tax Gap: Results of a GAO-Sponsored Symposium*, GAO/GGD-95-157, June 1995, pp. 7 & 8.

[41] The tax gap does not reflect subsequent activity, such as abatements that reduce the gap, or penalty and interest assessments that increase it. The estimates also relate only to payment of tax on income earned in legal activities. For example, the income tax theoretically due but not paid on income from distribution of narcotics is not included. Small Business Self-Employed (SB/SE) Compliance Risk Assessment, March 16, 2001; SB/SE Strategy, Research and Performance Management (SRPM) Research Reports for 2001, p. 2.

[42] The latest published income tax gap information is for 1992. National Headquarters Research has prepared partial estimates of the 1998 income tax gap in preparation for a draft report to Congress. SB/SE SRPM Compliance Risk Assessment, March 16, 2001. Appendix 1.

[43] SB/SE Strategy, Research and Performance Management (SRPM) Compliance Risk Assessment Research Report, March 16, 2001, p. 3.

[44] For a discussion of Sole Proprietor unreported and underreported income, see *infra*.

[45] Tax Year 2000 Nonfiler Data, SB/SE Research, September 25, 2003.

[46] GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, *Tax Administration: Tax Compliance of Nonwage Earners, GAO/General Government Division (GGD)*-96-165, Aug. 1996, p. 12.

In its August 2001 report on the IRS' ability to encourage accurate returns for non-employee compensation, TIGTA concludes "…a tax law change to require payers to withhold taxes from payments to independent contractors offers the best solution for increasing the accuracy of taxpayer identification number (TIN) information on Forms 1099-MISC (Miscellaneous Income) reporting non-employee compensation."[47] That is, taxpayers will be more likely to correct their TINs if they want to claim tax payments that have been withheld from payments.

In sum, we believe that withholding would offer the following benefits relative to current law:

- It would level the playing field between employers who correctly treat workers as employees, and those who do not, thereby eliminating an unfair business advantage.
- It would help non-wage workers avoid tax liabilities that they cannot pay.
- It would help bring non-wage workers into the tax system and thereby reduce the likelihood that they later will be subject to IRS enforcement and collection action.
- It would reduce the high rate of non-compliance among non-employee workers (by increasing reporting, payment, and filing) and thereby ensure that those who honestly pay taxes do not have to pay more than their fair share.

EXPLANATION OF RECOMMENDATIONS

Independent Contractors

Any person engaged in a trade or business, making payments of $600 or more for services provided by an individual, is required to report those payments on an information return.[48] Examples include fees, commissions, prizes and awards for services performed as a non-employee, and other forms of compensation for services performed for a trade or business by an individual who is not an employee.[49]

Our recommended change would require the service recipient not merely to issue information statements, but also to withhold federal taxes. Under our proposal, withholding would be imposed at a flat rate of five percent, except if the payment were partly in consideration of parts and materials, in which case the withholding rate generally would be 3 percent.[50] The payer would not be required to withhold tax if the aggregate amount of the payment is less than $600.

[47] Treasury Inspector General for Tax Administration, *Significant Tax Revenue May be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors*, Reference # 2001-30-132, Aug. 2001, p. ii.

[48] IRC § 6041A(a).

[49] Instructions for Form 1099-MISC 2003, p. MISC-4, Box 7, Nonemployee Compensation.

[50] See *infra* for a discussion of how we computed these withholding rates.

[51] As with Form W-4, Wage and Tax Statement, both civil and criminal penalties should apply for a substantial understatement or fraudulent statement of gross profit percentage. See, e.g. IRC §6682. IRC §6682 provides for a civil penalty of $500 for a false statement with no reasonable basis. This is in addition to any criminal penalty provided by §7205(a) for willfully supplying false or fraudulent information …be fined not more than $1,000 or imprisoned not more than 1 year or both.

The recommendation to withhold at a rate of 3.5 percent includes an exception to allow the service provider to elect to provide a statement of gross profit percentage.[51] The service provider is then required to withhold at the rate of five percent on the gross profit.

The National Taxpayer Advocate also recommends that the Secretary be authorized to develop industry-based recommended safe harbor gross profit percentages which the service provider can elect to apply for withholding tax purposes. It is anticipated that the IRS will work with industry associations and groups in developing these percentages.

Fishing Boat Proceeds

The operator of a fishing boat that normally carries a crew of less than ten[52] is required to report certain monies paid to crew members, representing a share of the proceeds of the catch, on a Form 1099-MISC.[53] On the same form, the operators must also report cash payments which do not exceed $100 per trip per person that are contingent on a minimum catch and paid solely for additional duties (such as mate, engineer, or cook) for which cash payments are traditional in the industry.[54]

The recommendation to withhold federal taxes at a rate of five percent is directed at:

- payments that represent a share of the proceeds from the sale of a catch paid in money, and
- cash payments that do not exceed $100 per trip, are contingent on a minimum catch, and are paid for additional duties described in IRC § 3121(b)(20)(A).

Federal Contractors

Internal Revenue Code section 6050M requires every federal agency head who enters into certain contracts to file a Form 8596 (Information Return for Federal Contracts) with the IRS to report information about persons with whom they have entered into contracts, including the date of contract action and the total amount to be paid under the contract. In addition, Internal Revenue Code section 6041A requires any service recipient engaged in a trade or business and paying for services to make a return according to regulations when the aggregate of the amount paid is $600 or more. Government entities are specifically required to make an information return, reporting payments to corporations as well as individuals.[55]

In the case of payments for services reported by heads of federal agencies on Forms 1099-MISC, we recommend, generally, a flat 5 percent withholding rate on the gross reportable payments. In those situations where the federal contractor provides materials and supplies, and the reportable payment includes reimbursement for those materials and supplies, the

[52] IRC § 3121(b)(20).

[53] IRC § 6050A.

[54] IRC § 3121(b) defines employment and lists certain exceptions to the term. IRC §3121(b)(20)(A) states that this type of payment to crew members cannot exceed $100 and still be considered non-employment.

[55] IRC § 6041A(d)(3)(A).

withholding rate should be 3.5 percent of the gross reportable payments. The federal contractor can make an election to provide the gross profit percentage in a statement to the payer. The payer, on subsequent gross reportable payments, will apply the rate of withholding at 5 percent to the gross profit calculated for the purpose of withholding.[56]

Businesses With Inventories

The National Taxpayer Advocate recommends that service recipients withhold federal income tax at the rate of 3.5 percent on gross reportable payments to service providers that maintain inventories. This rate would apply to businesses that provide services, parts, and materials when the total amount is reported on 1099-MISC as required by Proposed Regs 1.6041A-1(a)(2).

The National Taxpayer Advocate further recommends that service providers whose gross receipts include payments partly made for supplies and materials be permitted to make an election for withholding to apply to the service provider's estimated gross profit. In making the election, the service provider would be required to furnish the service recipient with a form that specifies the service provider's gross profit percentage. Upon receipt of the election statement, the service recipient will withhold tax at a rate of 5 percent on the gross profit, as computed by applying the gross profit percentage to subsequent reportable gross payments. Moreover, the Secretary should be authorized to create safe harbor gross profit percentages for specific trades and industries that, if used, would be grounds for not imposing a penalty for substantially understating the gross profit percentage.

Calculation of Withholding Rates

IRS data on sole proprietorships (Schedule C filers) indicate that businesses likely to have inventories based on North American Industry Classification System (NAICS) code descriptions include the following industries: construction; manufacturing; wholesale trade; retail trade; transportation and warehousing; barbers/beauty/nail salons; and funeral homes.[57] According to the IRS,

- The expenses of sole proprietorships with inventories are approximately 78 percent of gross receipts.
- The expenses of sole proprietorships without inventories are approximately 71 percent of gross receipts.[58]

[56] The IRS does not have data on overall noncompliance by federal contractors. The Department of Defense, which has about two-thirds of all federal contractors, is only in the early stages of working with the Federal Payment Levy Program (FPLP), which offsets federal payments against liabilities. The National Taxpayer Advocate recognizes that withholding on corporate contractors raises difficult administrative issues. The FPLP was devised, in part, to address these issues. We recommend, however, that withholding apply to federal contractors who are sole proprietorships, regardless of whether they provide a social security number or an employer identification number to the federal agency.

[57] Tax Year 2000, Schedule C Gross Receipts to Profits for Taxpayers with 1099 MISC Non-Employee Income, Compliance Research Information System (CRIS), Model IFM 2002.

[58] Tax Year 2000, Schedule C Gross Receipts to Profits for Taxpayers with 1099 MISC Non-Employee Income, Compliance Research Information System (CRIS), Model IFM2002.

For sole proprietorships without inventories, we determined that an appropriate withholding rate against net income would be 15 percent at a minimum, in order to cover the 15.3 percent self-employment tax imposed under SECA. Using the IRS data for sole proprietorship expenses, we computed a general gross profit percentage of 29 percent (gross receipts – 71 percent expenses).[59] We applied a 15 percent tax rate against the 29 percent gross profit percentage to arrive at 4.35 percent. We rounded that rate up to five percent rate applicable to reportable gross receipts to cover withholding for both self-employment tax and some federal income tax.

For businesses with inventories, we computed a general gross profit percentage of 22 percent (gross receipts – 78 percent expenses, based on IRS sole proprietorship data). We then applied the 15 percent tax rate against this 22 percent gross profit percentage. We rounded up the resulting 3.3 percent rate to a 3.5 percent withholding rate applicable to reportable gross receipts for businesses with inventories.

In cases where a service provider bears out-of-pocket expenses to furnish materials or supplies, the theoretically "pure" approach would be to require the service recipient to determine, and then back out, the cost of these parts, materials, and other expenses, and thereby to compute the service provider's net profit. We would then impose the desired 15 percent withholding rate on that profit. In practice, we are concerned that requiring that amount of additional work on the part of service recipients may prove overly burdensome. Thus, we have attempted to account for the additional cost of materials and supplies by applying a lower withholding rate to gross reportable payments for services and materials. We also recommend that the service provider be permitted to elect to provide a gross profit percentage to the service recipient, in which case withholding will be applied at the higher rate.

[59] We acknowledge that technically, in using the IRS sole proprietorship data, we should call this ratio the "net profit percentage." We use the term "gross profit percentage" for purposes of simplicity. We anticipate that these proposed withholding rates will be (and should be) subjected to intense scrutiny and review in order to arrive at the appropriate level. We also expect these rates to be adjusted from time to time to reflect current data.

3 FEDERAL TAX RETURN PREPARERS: OVERSIGHT AND COMPLIANCE

PROBLEM

Over 55 percent of the almost 130 million U.S. individual taxpayers paid a return preparer to prepare their 2001 federal income tax returns.[1] Of the 1.2 million known tax return preparers, approximately 300,000 to 600,000 are not regulated by any licensing entity or subject to minimum competency requirements. Anyone can prepare federal tax returns for others for a fee regardless of his or her education, training, experience, skill, or knowledge. Taxpayers, with limited tax knowledge themselves, are ill-equipped to assess the competency of someone's expertise in taxes and tax preparation.

All return preparers – whether attorneys, certified public accountants, enrolled agents, or unenrolled return preparers – must comply with certain requirements in the actual preparation of a return for a fee, including signing the return and furnishing a copy of the return to the taxpayer. Failure to satisfy these obligations can result in the imposition of a penalty against the return preparer. Preparers are also subject to penalties if they act in negligent or intentional disregard of Treasury or IRS rules and regulations. In calendar years 2001 and 2002, the IRS assessed preparer penalties totaling $2.4 million and collected $291,000, only 12 percent of the amount assessed.[2]

Not all documents prepared by a return preparer for a fee are required to be signed by that preparer. For example, if a return preparer prepares Form 656, Offer in Compromise, or an accompanying Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals for a fee, he or she is not required to sign those forms. The IRS estimates that many offers are submitted by "offer shops" – entities that charge taxpayers relatively large fees and submit incomplete and/or inaccurate offers. Since the IRS cannot track these preparers, it cannot discipline them.

Preparers of returns or refund claims involving the Earned Income Tax Credit (EITC) must satisfy certain due diligence requirements or be subject to a penalty. Of the $11 billion of EITC overclaims identified in the Tax Year 1999 EITC compliance study, over 57 percent was attributable to returns prepared by paid preparers. The IRS plans to conduct compliance visits to 240 preparers in FY 04, mail educational postcards to 20,000 preparers, and educate approximately 15,000 preparers at Tax Forums. Meanwhile, for the period from FY 2001 to FY 2003, the IRS has assessed only 163 EITC due diligence penalties, amounting to $666,250, and has collected only $233,724 of those penalties.[3]

1 General Accounting Office, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS Is a Challenge*, GAO-04-70 (October 2003) 1. (Hereinafter, "GAO Study.")

2 Id. 16.

3 ERIS Preparer Penalty Data, Office of Enforcement Revenue Data, December 1, 2003. During this period, the IRS assessed $714,550 in EITC due diligence penalties but later abated $48,300.

Electronic Return Originators (EROs) – persons or entities that originate electronically filed returns – are subject to minimum background and tax checks. Of the over 100,000 active EROs registered with the IRS for tax year 2003, the IRS completed 960 visits, and issued 106 written reprimands, 120 warnings, and 75 suspensions.[4] The IRS has no statutory authority to impose monetary penalties against repeat offenders of ERO program requirements. The IRS estimates that 80 percent of fraudulent returns are electronically filed.[5]

EROs are required to advise taxpayers that products such as Refund Anticipation Loans (RALs) are actual loans. They are prohibited from charging a fee based on a percentage of the refund or any return entry. Ninety percent of electronically filed fraudulent returns involve a RAL product.[6] RAL fees have been documented to be equivalent to a 400 to 900 percent annual interest rate, and a combination of return preparation, e-filing, RAL or check-cashing fees can reduce a taxpayer's refund by as much as one-third.[7]

Tax return preparers, including e-file partners, are prohibited from knowingly or recklessly disclosing or using information furnished in the course of preparing a tax return for other than return preparation purposes. Under certain circumstances, the taxpayer can consent to such disclosure or use. All too frequently, taxpayers consent to their preparer sharing data in response to inadequate or confusing disclaimers and consent requests. Further, many commercial enterprises identified the annual filing of the federal tax return as a valuable cross-marketing opportunity. Tax return preparation now occurs in pawn shops, furniture rental stores, check-cashing and convenience stores, and car dealerships with refunds applied to the purchase of merchandise. In most, if not all instances, these preparers are not required to demonstrate any minimum competency in tax preparation.

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations to impose an effective oversight and penalty regime for return preparers and others associated with the commercial tax preparation sector.[8]

4 Minutes of IRS Return Preparer Symposium, October 21, 2003, 3.

5 Id. at 5. If an ERO is a return preparer under § 7701(a)(36), the preparer penalties under IRC§§ 6694 and 6695 will apply. These penalties, however, do not address all of the potential improper practices by EROs.

6 Id.

7 GAO Study, supra note 1, at 10-11.

8 The National Taxpayer Advocate is directing the focus of these recommendations to that part of the preparer population that generally serves low and moderate income taxpayers and small businesses (including self-employed individuals). She supports many of the initiatives currently being considered by Congress, Treasury, and law and accounting associations aimed at curbing tax practitioner excesses associated with technical corporate tax shelters and other abusive tax schemes. The National Taxpayer Advocate believes, however, that segments of the unenrolled return preparer community constitute just as grave a danger, in the long term, to the tax system.

Establish a registration, examination, certification, and enforcement program for federal tax return preparers (FTRP).[9] Toward that end, Congress should direct the Secretary to establish a joint task force, on which the National Taxpayer Advocate, representatives from the Department of Treasury, the IRS, the Federal Trade Commission, State tax and consumer protection agencies, nonprofit consumer protection agencies, and tax professional associations shall serve 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. The Task Force should submit its report and recommendations to the House Committee on Ways and Means and the Senate Finance Committee within one year of enactment.

Increase the IRC § 6694(a) preparer penalty for understatements due to unrealistic positions from $250 to $1,000, and the IRC § 6694(b) penalty for intentional disregard of the rules and regulations from $1,000 to $5,000.

Increase the preparer penalties under IRC §§ 6695(a) through (e) with respect to certain requirements for preparation of income tax returns for other persons, from $50 per occurrence to $100 per occurrence.

Increase the preparer penalty under IRC § 6695(f) for negotiation of a refund check from $500 per check to $1,000 per check.

Amend IRC § 6695(g) to impose a tiered penalty structure for violation of the EITC due diligence requirements: for the first year in which a penalty is imposed, the penalty would be $100 per occurrence; for the second year, $500 per occurrence; and for the third year, $1,000 per occurrence. Provide for waiver, or abatement of penalties, in whole or in part, where the preparer enrolls in EITC education courses and demonstrates an ability to comply with due diligence requirements.

Amend IRC § 6695(g) to require the EITC due diligence certification to be signed, under penalties of perjury, by the return preparer and attached to the taxpayer's income tax return; that it include a description of how and when the preparer obtained the information upon which he based the EITC eligibility determination (for example, from original documents, the taxpayer's statements, or from prior year's records); and that the preparer be required to certify that he or she has a system of recordkeeping for the information outlined in the regulations and a record retention policy of three years.

Amend IRC § 6695 to authorize the Secretary to impose a civil penalty against a tax return preparer who, by reason of intentional misstatement, misrepresentation, fraud, or

[9] This recommendation was originally proposed in the National Taxpayer Advocate's 2002 Annual Report to Congress, Pub. 2104 (Rev. 12-2002), pages 216-230.

deceit or any unlawful act causes a taxpayer a tax liability attributable to the Earned Income Tax Credit, in an amount equal to the tax attributable to the disallowed EITC.

Amend IRC § 6695 to impose a penalty of $100 per occurrence on persons who fail to sign or include certain information on specified IRS forms prepared by them for a fee, including applications for offers-in-compromise, financial information statements of individuals and businesses, and similar forms.

Amend the Internal Revenue Code to authorize the Secretary to impose a $1,000 penalty, in addition to other available sanctions, on Electronic Return Originators who repeatedly fail to comply with ERO Program requirements. Where preparers, including EROs, commit violations by charging a fee for services that is a percentage of the taxpayer's refund or is based on a return item, or failing to advise the taxpayer of the fact that a Refund Anticipation Loan product is a loan and the terms of that loan, the penalty shall be the greater of $100 per occurrence or 50 percent of the fee for such service.

Amend the Internal Revenue Code to authorize the Secretary to impose a $1,000 penalty per occurrence against any person who willfully and intentionally misrepresents his or her professional status on a Power of Attorney authorizing him or her to represent a taxpayer before the Internal Revenue Service, or who willfully and intentionally practices before the IRS without proper authorization, under rules prescribed by the Secretary.

Increase the preparer penalty under IRC § 6713 for unauthorized disclosure or use of information by preparers from $250 to $500 per disclosure or use, and increase the aggregate amount of penalties imposed on a preparer during any calendar year from $10,000 to $25,000.

Require the Secretary, in consultation with the National Taxpayer Advocate, to study the impact that cross-marketing tax preparation services with other consumer products and services has on the accuracy of returns and tax compliance, and report the results of that study to the House Committee on Ways and Means and the Senate Committee on Finance within one year of its establishment.

Require the Commissioner of Internal Revenue to appoint two consumer protection advocates to the Electronic Tax Administration Advisory Committee.

In addition to legislative recommendations described above, the National Taxpayer Advocate makes two administrative recommendations:

- Include a checkbox on all returns and other submissions that require a preparer signature, for the preparer to enter his or her category of return preparer (e.g., attorney, CPA, enrolled agent, or unenrolled preparer). This information will help the IRS better focus its preparer education, outreach, and compliance efforts.

- Develop a simple, easy-to-read pamphlet that explains to taxpayers their protections under IRC §§ 6713 and 7216, their right to refuse to consent to disclosure or use of information by return preparers, and what constitutes a valid consent under the regulations.

PRESENT LAW

Definition of Tax Return Preparer and Practice Before the IRS

A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, a tax return or a claim for refund (or a substantial portion thereof).[10] The Code further provides that a tax return preparer includes any person who furnishes the taxpayer with sufficient information and advice so that the completion of a return is largely a mechanical or clerical matter. Treasury regulations specifically state that "a person may be an income tax return preparer without regard to educational qualifications and professional status requirements."[11]

Lawyers, accountants, and enrolled agents are subject both to their own professional standards and those of Treasury Department Circular 230 (Circular 230).[12] Circular 230 describes who may practice before the IRS, establishes minimum standards for that practice, and sets forth a hierarchy of discipline for those who violate those standards.[13] Unenrolled return preparers are only authorized to represent a taxpayer with respect to a return prepared by that preparer.[14] They may not represent the taxpayer before the IRS with respect to collection matters or returns prepared by someone other than the preparer. Thus, unenrolled return preparers generally are governed only by the Code's penalty provisions applicable to tax return preparers.[15]

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[10] IRC § 7701(a)(36).

[11] Treas. Reg.§ 301.7701-15(a)(3).

[12] 31 CFR part 10. Although the scope of Circular 230 is currently under review by the IRS, current practice is that sanctions against certified public accountants, attorneys and enrolled professionals do not prevent them from preparing Federal tax returns for a fee. Office of the Senior Counselor and the Office of Professional Responsibility website at http://www.irs.gov/taxpros/agents/index.htm/

[13] Circular 230 defines "practice" before the IRS as including:

> all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a client's rights, privileges, or liabilities under the laws or regulations administered by the Internal Revenue Service. Such presentations include preparing and filing necessary documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings.

Circular 230, § 10.2.

[14] Id. at 10.3. See also Rev. Proc. 81-38, 1981-2 C.B. 592.

[15] Unenrolled return preparers also may not appear before the Office of Appeals. An unenrolled preparer who exceeds his scope of authority may be barred from further representation. Such a preparer can contrive to prepare returns, however, and he will not be subject to monetary penalties for unauthorized practice. The states of California and Oregon regulate persons who prepare Federal and State tax returns. *See* the Tax Preparers Act, Chapter 14, California Business and Professions Code, § 22255; OR. Admin. R. 800-25-0020.

The IRS Office of Professional Responsibility conducts investigations and disciplinary proceedings of practitioners authorized to practice before the IRS and makes recommendations for discipline, where warranted. Attorneys, certified public accountants, and enrolled agents and actuaries who have violated one of the practice rules may be subject to censure (private and public), suspension, or disbarment.[16]

Obligations of Tax Return Preparers

Tax return preparers must comply with certain minimum requirements under the Code. Section 6107(a) requires tax return preparers of any return or refund claim to furnish a completed copy of that return or claim to the taxpayer no later than the time it is presented to the taxpayer for signature. Preparers must also provide, on any return or refund claim he or she prepares, an identifying number that will enable the IRS to properly identify the preparer, his or her employer, or both, as prescribed by the Secretary.[17] Employers of preparers must maintain a list of all preparers employed by that person at any time during the year.[18]

Finally, IRC § 6107(b) provides that for any return or refund claim prepared by a tax return preparer, he or she must retain a copy of that return or claim, or a list of the name and taxpayer identification number of the taxpayer for whom the return was prepared, for a three year period following the close of return period.[19] Such copy or list must be made available for inspection upon request by the Secretary.

Tax Return Preparer Civil Penalties

Internal Revenue Code section 6694 imposes several penalties on income tax return preparers who understate a taxpayer's tax liability. Where a preparer has taken a position on a return or refund claim[20] for which he or she knew or should have known that there was "not a realistic possibility of being sustained on its merits," that preparer shall be subject to a $250 penalty, absent a showing of reasonable cause for the understatement.[21] A preparer will be subject to a $1,000 penalty if the understatement is attributable to the preparer's willful attempt to understate the tax liability or is due to the preparer's reckless or intentional disregard of rules or regulations.[22]

[16] Circular 230, § 10.50(a).

[17] IRC § 6109(a)(4).

[18] IRC § 6060; Treas. Reg. § 1.6060-1(a).

[19] IRC § 6060(c) defines the term "return period" as the 12-month period beginning on July 1 of each year.

[20] For purposes of IRC §§ 6694 and 6695, a "return" means any return of any tax imposed by Subtitle A of Title 26, and a "claim for refund" means a claim for refund of or credit against any such tax. IRC §§ 6696(e)(1), (2).

[21] IRC § 6694(a).

[22] IRC § 6694(b).

As noted above, tax return preparers must comply with statutory requirements for each income tax return or refund claim they prepare, including:

- Providing the taxpayer with a copy of the tax return as required by IRC § 6107(a);
- Signing the tax return (IRC § 6695(b));
- Providing his or her identifying number on the tax return pursuant to IRC § 6109(a)(4); and
- Maintaining and preserving a copy or list of all such returns for three years after the close of the return period as required by IRC § 6107(b).

Where a tax return preparer fails to satisfy any of these requirements, he or she shall be subject to a $50 penalty for each failure, subject to an annual maximum penalty of $25,000. The preparer may avoid liability if he or she shows that the failure was due to reasonable cause.[23]

Internal Revenue Code section 6695(e) imposes a penalty on a person who fails to maintain the list of tax return preparers employed by that person, as required under IRC § 6060, or who fails to provide information required to be included on such list. The penalty is $50 for each failure to maintain the list and each failure to provide required information. The penalty is subject to waiver or abatement for reasonable cause.

In addition to the above requirements and associated penalties, a preparer who "endorses or otherwise negotiates" a federal tax refund check payable to another taxpayer shall pay a $500 penalty for each check. This penalty does not apply if the preparer is depositing the check into the taxpayer's account for the taxpayer's benefit.[24]

The civil penalties imposed under IRC §§ 6694 and 6695 are applicable in addition to any other penalties applicable to the situation. These preparer penalties are assessed without regard to the deficiency procedures under IRC § 6212.

Internal Revenue Code section 6713 imposes a penalty on any person who prepares returns or provides services in connection with preparation of a return and who (1) discloses any information furnished to him for, or in connection with, return preparation, or (2) uses such information for purposes other than preparing or assisting in the preparation of that return. The penalty is $250 per occurrence, subject to an annual cap of $10,000.[25] The penalty does not apply if the disclosure is made pursuant to another section of the Code or pursuant to Court order.[26] Deficiency procedures do not apply to this penalty.[27]

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[23] *See* IRC §§ 6695(a) – (d).

[24] IRC § 6695(f).

[25] IRC § 6713(a).

[26] IRC § 6713(b) (Cross referencing IRC § 7216(b)).

[27] IRC § 6713(c).

Tax Return Preparer Criminal Penalties

Tax return preparers are also subject to criminal sanctions arising from their preparation of returns or other documents. Criminal penalties can be imposed for:

- The willful attempt to evade or defeat tax;[28]
- The willful making of false statements under penalties of perjury;[29] and
- The willful aiding, assisting, counseling, or advising in the preparation of any document in connection with the Internal Revenue laws that is false or fraudulent with respect to a material matter.[30]

Section 7216(a) makes it a misdemeanor for a preparer to knowingly or recklessly disclose any information provided to him or her in connection with the preparation of a return, or use that information for any non preparation-related purpose. The preparer may be subject to a fine of up to $1,000 and/or imprisonment of up to one year.[31]

Injunctive Relief

Under Internal Revenue Code section 7407(a), the IRS has the authority to bring a civil action in the Federal District Court to seek an injunction to prohibit certain specified actions of income tax return preparers. Preparers who engage in practices that would subject the preparer to penalties under IRC §§ 6694 and 6695, misrepresent their education or experience as an income tax preparer or their eligibility to practice before the IRS, engage in fraud or deceptive conduct, or guarantee the payment of a tax refund or the allowance of a tax credit may be enjoined from engaging in such practices under IRC § 7407(b). Where the court determines that a preparer has continuously or repeatedly engaged in one of the practices specified above, the court may also enjoin the preparer from acting as an income tax return preparer.[32]

Earned Income Tax Credit Due Diligence Requirements

Internal Revenue Code section 6695(g) imposes a penalty on any income tax return preparer who prepares a return or claim for refund involving the Earned Income Tax Credit (EITC) and who fails to meet certain due diligence requirements for determining the taxpayer's eligibility for or amount of the credit. The penalty is $100 for each failure to meet such due diligence requirements.

[28] IRC § 7201.

[29] IRC § 7206(1).

[30] IRC § 7206(2).

[31] A preparer who discloses such information in response to a court order or as required by some other Code provision is not subject to criminal sanctions. IRC § 7216(b)(1). Similarly, a preparer who uses this information in connection with the preparation of the taxpayer's State and local tax returns and estimated tax declarations shall not be subject to criminal penalties. *See* Treas. Reg. 301.7216-2 for additional exceptions.

[32] IRC § 7407(b).

The due diligence requirements are established by Treasury Regulations. EITC tax return preparers are required to:

- Complete an eligibility checklist (or a substantially similar form devised by the preparer) based on information provided by the taxpayer to the preparer or otherwise reasonably obtained by the preparer.[33] IRS has issued Form 8867, Paid Preparer's Earned Income Credit Checklist, for this purpose.
- Compute the credit by using the EIC worksheet in tax return instructions (or some other substantially similar worksheet devised by the preparer).[34] IRS includes this worksheet in instructions to Forms 1040, 1040A, and 1040EZ as well as in Publication 596, Earned Income Credit.
- Not know, or have reason to know, that any information used by the preparer in determining the taxpayer's eligibility for, or the amount of, the EIC is incorrect. The regulations state that "[t]he preparer may not ignore the implications of information furnished to, or known by, the preparer, and must make reasonable inquiries if the information furnished to, or known by, the preparer appears to be incorrect, inconsistent, or incomplete." [35]
- Retain the following information for a period of three years after June 30 following the date the preparer presented the return to the taxpayer for signature:
    - a copy of the completed eligibility checklist or substitute;
    - a copy of the computation worksheet or substitute; and
    - a record of how, when, and from whom the information used to prepare the checklist and worksheets was obtained.[36]

A preparer may avoid the penalty even where due diligence requirements are not met if he or she can show that normal office procedures are reasonably designed and routinely followed so as to comply with the due diligence requirements and that the particular failure was isolated and inadvertent.[37]

Electronic Return Originators

An Electronic Return Originator (ERO) originates the electronic submission of income tax returns.[38] To become an ERO, an individual, business or organization must apply to and be accepted by the IRS. Application procedures are included in Publication 3112, The IRS e-file Application Package.

[33] Treas. Reg. § 1.6695-2(b)(1).

[34] Treas. Reg. § 1.6695-2(b)(2).

[35] Treas. Reg. § 1.6695-2(b)(3).

[36] Treas. Reg. § 1.6695-2(b)(4).

[37] Treas. Reg. § 1.6695-2(c).

[38] Rev. Proc. 2000-31, Sec. 3.01.

Electronic Return Originators are considered tax return preparers for purposes of IRC § 7216, which imposes criminal sanctions for the knowing or reckless unauthorized disclosure or use of tax return information.[39] Treasury Regulations provide that persons, including EROs, are not considered tax return preparers within the definition of IRC § 7701(a)(36) – and thus are not subject to other preparer penalties – if their services with respect to returns are limited to the following actions:

- Typing, reproductions or other mechanical assistance in the preparation of return or claim for refund; or
- Making nonsubstantive changes, such as correcting a transposition, spelling, or arithmetic error ("mechanical assistance").[40]

Prior to becoming an ERO, the IRS reviews the applicant's suitability, including a tax filing and payment history check on personal and business returns; a criminal background check; a check for a history of prior non-compliance with the e-file program; and a check for a history of IRS penalties. EROs are not permitted to charge fees that are based on a percentage of the taxpayer's refund amount or on a figure from the taxpayer's return. Further, if EROs offer Refund Anticipation products, they must advertise such products as loans.[41]

Electronic Return Originators are subject to three sanction levels, none of which is a direct monetary penalty, although some can have substantial economic impact for the ERO. The three sanctions are:

- Issuance of warning or be "written up";
- Loss of e-file privileges for one year; and
- Suspension of e-file privileges for the remainder of the year plus two additional years in instances of fraudulent or "known criminal activity."[42]

Electronic Tax Administration Advisory Council (ETAAC)

Section 2001(b)(2) of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) required the Secretary to convene an electronic commerce advisory group to ensure that he receive "input from the private sector in the development and implementation of the plan" for increasing electronic filing of Federal tax and information returns and for cooperating with and encouraging competition with the private sector. This group is specifically required to include representatives from the small business community and from the tax practitioner, preparer, and computerized tax processor communities, as well as other representatives from the electronic filing industry.

[39] Id. at Sec. 6.01.1.

[40] Treas. Reg. § 301.7701-15(d).

[41] GAO Study, *supra* note 1, at 17.

[42] Internal Revenue Service, Publication 1345, *Handbook For Authorized IRS E-File Providers of Individual Income Tax Returns*, (Rev. 2001), pp. 77-78.

The Electronic Tax Administration Advisory Committee (ETAAC) was created in 1998. In accordance with RRA 98, it is required to submit annual reports to several committees of Congress on the IRS' progress toward meeting its 80 percent electronic filing goal by 2007; the status of the IRS e-filing strategic plan; any legislative changes that would assist the IRS in meeting that goal; and the effects on small businesses and the self-employed of electronically filing tax and information returns.[43]

REASONS FOR CHANGE

Oversight of Tax Return Preparers

The National Taxpayer Advocate recognizes the important role that tax return preparers, regardless of their professional designation, play in maintaining the integrity of the United States tax system. Not only do preparers ensure that information is accurately submitted to the IRS and educate their clients, but they also keep the IRS and Treasury "honest" by challenging their positions, formally through the administrative and judicial processes as well as in informal discussions and presentations.

The National Taxpayer Advocate does not wish in any way to impair that dialogue or interfere with tax assistance provided to taxpayers by competent professionals. She is concerned, however, about the persistent problems that have surfaced over the years with regard to tax return preparers, particularly unenrolled return preparers. In 1976, when Congress enacted the requirements for preparers to sign returns and provide copies to taxpayers, along with the penalty provisions of IRC §§ 6694 and 6695, it explicitly recognized the problems that unskilled or unscrupulous preparers can have on the tax system and the harm they can inflict on taxpayers.[44]

More recently, the General Accounting Office (GAO) estimated as many as 2 million taxpayers overpaid their 1998 taxes by $945 million by claiming the standard deduction instead of itemizing their deductions – and that over half of these taxpayers used paid preparers.[45] The Treasury Inspector General for Tax Administration (TIGTA) found that taxpayers on 230,000 returns filed by paid preparers in tax year 2001 were eligible for, but did not claim, the Additional Child Tax Credit.[46] Finally, the IRS' Tax Year 1999 EITC

[43] Pub. L. No.105.206 §2001(d) (1998). The ETACC's most recent report, dated June 30, 2003, can be found at http://www.irs.gov/taxpros/article/0,,id=112073,00.html

[44] In its explanation of the Tax Reform Act of 1976, the Joint Committee on Taxation noted that

> [t]he past few years have seen a substantial increase in the number of persons whose business is to prepare income tax returns for individuals and families of moderate income. . . . Some abuses have arisen in the preparation of wage earners' returns for a relatively small fee. In some of these cases, return preparers have made guarantees that individuals would obtain a refund because of the tax expertise of the preparer. In other cases, return preparers have suggested that a taxpayer sign a blank return (i.e., before it was prepared).

Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, (H.R. 10612, 94th Cong., Pub. L. 94-455), JCS-33-76 (Dec. 29, 1976), 346. See also S. Rep. No. 94-938 at 349-50.

[45] GAO-02-509, *Tax Deductions Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes By Not Itemizing*, March 2002, p.3

[46] Treasury Inspector General for Tax Administration, *Analysis of Statistical Information for Returns with Potentially Unclaimed Additional Child Tax Credit* (Washington, DC: January 2003), p.2.

compliance study identified returns with $11 billion in overclaims and $710 million in underclaims of the credit.[47] Preparers prepared over 63 percent of those returns. In fact, preparers prepared over 68 percent of all EITC tax year 2001 returns.[48] Taxpayers themselves recognize the value of going to competent preparers. A GAO survey found that most taxpayers using a preparer believed it was beneficial and that they would use one again.[49] The report noted, however, that during in-depth interviews, taxpayers acknowledged that they found tax laws confusing, so these taxpayers may not have known enough to actually judge the quality of the tax preparer's services. Moreover, GAO observed that:

> While available evidence does not allow a precise estimate of how extensive the problem is, none of the evidence suggests that the percentage of poorly served taxpayers is large. Nevertheless, even a small percentage of the over 72 million taxpayers who used paid preparers in 2001 translates into millions of taxpayers who potentially overpaid or underpaid their taxes due to preparer mistakes or other problematic behavior.[50]

In the IRS' formal response to the National Taxpayer Advocate's 2002 legislative recommendation proposing registration, testing, and certification of unenrolled return preparers, the Service stated that there should be "more information about the scope of the problem before determining whether legislation establishing federal regulation would provide any real benefits to taxpayers." [51]

The IRS, Congress, and the public have known about problems with some segments of the return preparer community since the mid-1970s. In instances where the IRS is able to uncover unacceptable return preparation by preparers, the enforcement of penalties remains a low priority. In fact, in some instances the IRS knows that there is a significant problem (e.g., with offer shops submitting inaccurate or incomplete offers-in-compromise) but because preparers are not required to sign these forms, the IRS cannot trace offenders. The IRS collected only 12 percent of the $2.4 million in penalties it assessed in calendar years 2001 and 2002. Moreover, despite the substantial evidence in the Earned Income Tax Credit program that paid-preparer returns contain errors and are, in some instances, fraudulent, the IRS is conducting only 240 audits of preparers in FY 2004. Thus, to argue that we don't know the size of a problem when all of our practices successfully avoid measuring it, is an inadequate response. If the IRS needs more proof, it should conduct research studies to obtain it.

[47] Department of the Treasury, Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Feb. 28, 2002), p. 21.

[48] EITC Program Office, EITC 2003 And Beyond, January 25, 2003.

[49] GAO Study, *supra* note 1, at 2.

[50] Id. at 2.

[51] Memorandum for National Taxpayer Advocate from Mark E. Matthews, IRS Deputy Commissioner for Services and Enforcement, December 22, 2003, at 1. A copy of this memorandum follows this Key Legislative Recommendation, infra.

The IRS recently announced its revamping of the Office of Professional Responsibility (OPR) and the additional resources it is dedicating to that office. However, to date, OPR's entire focus has been trained on high-end preparers – those who "push the envelope" with tax shelter opinion letters and other abusive schemes.[52] Yet these preparers are already subject to professional regulation by their licensing agencies and Circular 230. The preparers that the National Taxpayer Advocate is concerned about here, and who work with the vast majority of United States taxpayers, are those who are not subject to any professional licensing or to Circular 230. The increased resources of OPR will not make a difference in improving the quality of tax preparation by these preparers, nor will it provide any remedy to taxpayers who have been harmed by those preparers.

Return Preparer Penalties

Congress first imposed requirements on return preparers with respect to signing and maintaining records of returns in 1976.[53] The penalties under IRC § 6694 for understatement of a taxpayer's liability by a tax return preparer were last increased in 1989, as were the penalty amounts under IRC § 6695. At these monetary levels, preparers against whom penalties are assessed view them as merely a cost of doing business.

The Internal Revenue Manual states that penalty assertion is the key enforcement vehicle for noncompliant preparers.[54] In calendar years 2001 and 2002, the IRS asserted $2.4 million in preparer penalties and collected $291,000, or 12 percent of penalties asserted. Although the IRS collected all or part of the penalty from 44 percent of the preparers against whom penalties were assessed, the uncollected amount represents 88 percent of the value of penalty assessments.[55]

The IRS admits that "collecting paid preparer penalties has not been a priority in the [IRS'] collection efforts due to other higher priority work, such as abusive tax schemes."[56] A representative of the Small Business/Self-Employed Operating Division (SB/SE), which is responsible for assessing and collecting penalties against paid preparers, stated that SB/SE "cannot afford to make these low dollar paid preparer cases a priority given their responsibility for addressing billions of dollars in uncollected taxes."[57] GAO then observed:

> However, the monetary amounts of these penalties, which are small relative to IRS's other compliance efforts, may not reflect how important the penalties are as a deterrent to problematic paid preparers. . . . IRS has no data on

[52] *See* David Cay Johnston, "IRS Unit Will Focus on Lawyers and Accountants", New York Times, Dec. 29, 2003.

[53] *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1203(b)(1).

[54] I.R.M. 4.10.6.8.2(1) (May 14, 1999).

[55] GAO Study, *supra* note 1, at 16.

[56] Id.

[57] Id.

> the extent of the problems with paid preparers or how effective its enforcement efforts are in deterring problematic preparer behavior. In assessing but not collecting these penalties, IRS may be sending preparers a mixed message about whether poor performance by preparers will be tolerated.[58]

This same pattern of limited resources and thus limited activity is present in the Earned Income Tax Credit area. Despite substantial empirical and anecdotal evidence of preparer error and over-reaching, the IRS plans only 240 audits of EITC return preparers during Fiscal Year 2004.[59] Current audit practices for preparer penalties are labor intensive, involving visits from Tax Compliance Officers (TCOs) or Revenue Agents (RAs). IRS plans to rely on outreach and education efforts to improve EITC preparer compliance.[60]

[58] GAO Study, *supra* note 1, at 16-17.

[59] W&I EITC Due Diligence Briefing, November 17, 2003.

[60] Id. EITC Program Office.

Table 2.3.1 shows assessments and collections for various civil preparer penalties for fiscal years 2001 through 2003.

TABLE 2.3.1, ERIS PREPARER PENALTY DATA AS OF SEPTEMBER 2003

Fiscal Year	IRC	Ref Number	Master File*	Assessment Cnt1	Assessment Amt	Abatement Cnt2	Abatement Amt	Collection Cnt3	Collection Amt
2001	6694	645	BMF	7	$1,750	0	$-	4	$1,000
			IMF	168	$236,100	9	$4,500	100	$24,179
		646	IMF	6	$16,250	0	$-	6	$16,250
	6695	624	BMF	2	$5,500	0	$-	1	$500
		624	IMF	22	$34,135	1	$550	14	$10,385
		626	IMF	1	$500	0	$-	0	$-
		627	BMF	39	$142,800	5	$30,600	75	$45,025
		627	IMF	73	$243,800	3	$16,700	168	$93,745
	Total			318	$680,835	18	$52,350	368	$191,084
2002	6694	645	BMF	11	$5,750	0	$-	7	$4,550
	6694		IMF	143	$77,125	3	$750	117	$31,136
	6694	646	IMF	7	$7,250	0	$-	2	$500
	6695	624	BMF	4	$27,950	1	$7,500	2	$9,612
			IMF	29	$117,150	3	$14,100	14	$4,579
		627	BMF	11	$50,700	0	$-	5	$6,600
		627	IMF	31	$196,850	1	$1,000	52	$55,554
	Total			236	$482,775	8	$23,350	199	$112,531
2003	6694	645	BMF	38	$9,348	0	$-	5	$1,098
		645	IMF	122	$62,250	2	$500	72	$20,131
		646	BMF	1	$750	0	$-	0	$-
		646	IMF	7	$168,000	0	$-	1	$250
	6695	624	IMF	22	$4,450	0	$-	3	$201
		626	IMF	4	$4,000	0	$-	0	$-
		627	BMF	3	$22,900	0	$-	2	$20,000
		627	IMF	6	$57,500	0	$-	3	$12,800
	Total			203	$329,198	2	$500	86	$54,480
	Grand Total			757	1,492,808	28	$76,200	653	$358,095

*Master File = Form 8278 (Computation and Assessment of Miscellaneous Penalties) MFT 13 for BMF and MFT 55 for IMF.
Note 1 The number of assessment dates in a module.
Note 2 The number of abatements applied to a single assessment. More than one abatement can be applied to each assessment.
Note 3 The number of collections. More than one payment can be collected for each assessment.
IRC 6713 Ref Num 633 (Disclosure or use of information by a Return Preparer) - no activity for FY 2001 - 2003 and only 4 penalty assessments for FY 1996 - 1998.
IRC 6694 Ref Num 624, 626, and 627 Return Preparer, Preparer Negotiating Taxpayer Checks, Failure to Exercise due Diligence.
IRC 6695 Ref Num 645 and 646 Understatement of Taxpayers Liability by Return Preparer and Understatement of Taxpayers Liabality by Return Preparer due to willful or reckless conduct.
Reference Number 645 - 6694(a) - Understatement of Taxpayer's Liability by Return Preparer due to unrealistic position
Reference Number 646 - 6694(b) - Willful attempt to Understate Taxpayer's Liability

Signature Requirements

At present, the IRS is unable to determine with any accuracy the number of returns prepared by different categories of return preparers and what types of errors occur on them. This information could assist the IRS to target education and outreach efforts to different populations of return preparers. The IRS could obtain this information by including a box next to the preparer's signature line on which he or she would be required to record the category of return preparer –attorney, CPA, enrolled agent, or unenrolled preparer.

As noted above, tax return preparers are required to sign returns and refund claims. There is no legal requirement for a preparer to sign returns other than income tax or certain submissions to the Internal Revenue Service on behalf of a taxpayer, including Form 656, Offer in Compromise, and IRS forms pertaining to the taxpayer's financial information statement (Forms 433-A, 433-B, and 433). Further, the penalty for failing to sign returns or refund claims does not apply to these documents.

The IRS has identified a significant problem in the offer-in-compromise program relating to "offer shops" – specifically, those preparers that churn out offers-in-compromise on behalf of taxpayers without conducting due diligence checks.[61] In some instances, the preparers do not submit a power of attorney along with the offer, and the IRS only finds out after rejecting the offer that someone other than the taxpayer prepared it.[62]

The National Taxpayer Advocate believes that requiring preparers to sign offers-in-compromise and financial statements prepared by them, subject to IRC § 6695 penalties, will provide the IRS with a valuable tool to identify unskilled or unscrupulous preparers. Where preparers are authorized to practice before the IRS, the IRS can impose sanctions under Circular 230 and taxpayers themselves can seek relief from any state regulatory or licensing agencies. If, however, the preparer of the offer or other document is not subject to Circular 230, the IRS has no administrative recourse available. An unenrolled return preparer who prepares an offer-in-compromise or collection due process hearing request for a fee is "practicing" before the Internal Revenue Service without authorization under Circular 230. There are no monetary sanctions against the unenrolled return preparer for such unauthorized practice.

Earned Income Tax Credit Due Diligence Requirements

Treasury regulations require preparers of returns or refund claims claiming the Earned Income Tax Credit (EITC) to record how and when information used to complete the required EITC checklist and worksheet was obtained by the preparer, including the iden-

[61] See the discussion of offers-in-compromise and offer shops in Part 1 supra.

[62] In these situations, the taxpayer does not respond to IRS letters because he thinks his preparer will respond. The taxpayer finally calls the IRS when he receives a rejection letter and at that time he learns that the preparer supplied inaccurate information to the IRS and did not respond to IRS inquiries.

tity of any person furnishing the information.[63] Accordingly, the current IRS Form 8867, Paid Preparer's Earned Income Credit Checklist, does not require the return preparer to identify on the form how or when he or she obtained this information – that is, from original documents, the taxpayer's statements, or prior year's return preparation records.

As part of their EITC due diligence, preparers are prohibited from ignoring the implications of any information that they receive or know in the course of preparing the return and must make reasonable inquiries about this information if it appears to be "incorrect, inconsistent, or incomplete." IRS Form 8867 is not drafted in a manner that would require the preparer to ask follow up questions, even in the most obvious circumstances. For example, where the taxpayer did not claim a qualifying child in the prior tax year, and the preparer has knowledge of this fact, the form should prompt the preparer to ascertain and record what circumstances changed that enable the taxpayer to claim the qualifying child in the current year.

The IRS does not currently require EITC preparers to submit a signed Form 8867 (or acceptable substitute) with the taxpayer's return. Thus, the IRS cannot verify that the required due diligence was completed without conducting an examination of the preparer's records. Since neither the taxpayer nor the preparer are required to sign the form, a preparer who has been notified of an IRS visit can easily create a completed Form 8867 after filing the return, thereby defeating the purpose of the due diligence requirements.

The IRS plans to conduct audits of only 240 EITC preparers in fiscal year 2004, despite a documented overclaim rate of more than 29 percent .[64] Since current IRS audit procedures require an in-person visit by an IRS employee, these audits are time-consuming and resource intensive. Given the competing demands on these trained personnel, SB/SE is unable to conduct many due diligence audits. Although the IRS conducts education and outreach to the preparer community, it has not demonstrated the effectiveness of these efforts in reducing EITC errors; further, the threat of an audit and penalty assessment if violations continue is minimal.

The National Taxpayer Advocate's proposed changes to the Form 8867 – requiring it to be signed by the preparer and filed with the taxpayer's return and requiring the preparer to supply more information about how the he or she determined the taxpayer's eligibility for the EITC – will enable the IRS to conduct correspondence examinations of preparer due diligence. The revised form will also force preparers who might otherwise "look the other way" to articulate their reasons for preparing an EITC claim. This approach will increase the accuracy of EITC returns, and is measurable.

[63] Treas. Reg. § 1.6695-2(b)(4)(i)(C).

[64] Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns, (2/28/02). This data was derived from taxpayer answers to the examiners' question about how the return was prepared.

Electronic Return Originators

Electronic Return Originators are subject to three levels of sanctions by the IRS for failing to comply with e-file Program requirements. These sanctions include a warning or written reprimand; the loss of e-file privileges for one year; and the suspension from the e-file program for the balance of the year and two additional years for fraud or other known criminal activity. IRS monitors EROs through visits based on mandatory or random referrals.

The IRS has a goal of visiting 1 percent of the over 100,000 active e-file participants. In FY 2003 the IRS made 960 visits, which resulted in 106 written letters, 120 warnings, 50 recommended suspensions, and 25 immediate suspensions.[65] According to the IRS Criminal Investigation Division (CI), 70 percent of the 11,000 returns identified in fiscal year 2003 through its Questionable Return Program (QRP) were filed through EROs.[66] Further, over 90 percent of these fraudulent returns have a loan product associated with them.[67]

Unauthorized Disclosure and Use of Information by Preparers

The emphasis on electronic filing, coupled with the increase in the number and amount of EITC claims, has created a new product line for businesses not traditionally aligned with tax preparation services. Taxpayers are no longer limited to going to a preparer who only offers tax preparation and advice. Today, taxpayers can have their returns prepared in furniture rental stores and immediately apply their refund toward a furniture purchase.[68] In areas surrounding Native American Tribal Reservations, where taxpayers can receive their refund in advance in the form of a debit card, prices at participating businesses have been documented as increasing by 150 percent during January through May.[69] The impact on tax compliance and tax administration of this combination of tax preparation and commerce is unclear. At present, the IRS has no research underway to determine its impact, both in terms of the accuracy of returns generated by these preparers or their downstream consequences.

Tax return preparers, including e-file partners, are prohibited from knowingly or recklessly (1) disclosing any information furnished to him "for, or in connection with" the prepara-

[65] Id. at 3. According to the IRS, over 30% of ERO visits in FY 2003 resulted in some form of discipline. This result indicates a need for a more thorough, statistically valid study. On its surface, the discipline rate indicates a problem exists.

[66] Id. at 5. CI's Return Preparer Program (RPP) identifies and investigates criminal return preparers. Its Questionable Refund Program (QRP) identifies potentially fraudulent tax returns claiming refunds. For a detailed discussion of CI cases, see the discussion in this report, supra Part 1.

[67] Id. at 5. The General Accounting Office has noted that the IRS has no data on the extent of the problem with paid preparers, including those who are fraudulent, or the effectiveness of CI's deterrent actions against them. GAO Study, supra note 1 at 5.

[68] Jackson Hewitt Tax Service, Jackson Hewitt Forms Strategic Alliance with Rent-A-Center, November 5, 2003.

[69] Low Income Taxpayer Clinic Interview, March, 2001, on file with the National Taxpayer Advocate.

tion of a return[70] or (2) using any such information "for any purpose other than to prepare, or assist in preparing," any such return.[71] Violation of this requirement is a misdemeanor, subject to a fine of up to $1,000 or imprisonment of up to one year, or both.[72]

Treasury regulations set forth exceptions where information may be disclosed or used with and without the formal consent of the taxpayer.[73] Among other requirements, the regulations provide that where a tax preparer wants to solicit the taxpayer for other business that the preparer currently provides and offers to the public, he must satisfy the following requirements.

- The preparer must obtain a separate written consent, signed by the taxpayer (or his agent or fiduciary) for each separate authorized use or disclosure, including the name of the return preparer, the purpose for the consent, the date of the consent, a statement that the tax return information may not be disclosed or used by the preparer for any other purpose, and a statement by the taxpayer that he consents to the disclosure or use described in the consent document.
- The consent must be obtained no later than the time the taxpayer receives his completed tax return from the return preparer.
- If the taxpayer denies the request for disclosure and/or use, the preparer may not make a follow-up request.
- The return preparer may not use consents to solicit or furnish services by a third party, unless that third party and the return preparer are members of the same affiliated group.

The consent cannot be used to enable the return preparer to solicit additional business "some time in the future."[74]

The regulations under IRC § 7216 are currently under review and revision. The advent of electronic filing and self-help tax software packages raise many difficult issues with respect to taxpayer consents to disclosure and use of information obtained "for, or in connection with" tax preparation. In the context of a software program, how does one obtain separate consents for each disclosure or use? When is a tax return actually delivered to the taxpayer? That is, if a taxpayer e-files the return but re-opens the software program later

[70] IRC § 7216(a)(1).

[71] IRC § 7216(a)(2).

[72] IRC § 7216(a). These penalties do not apply to disclosures made pursuant to a court order or to any other Code provision, and to use of the information in preparation of state and local tax returns and estimated tax declarations. IRC § 7216(b)(1) and (2).

[73] IRC § 6713 provides a civil penalty counterpart to the criminal sanctions of IRC § 7216. The exceptions to disclosure under IRC § 7216 also apply to the civil penalty. IRC § 6713(c). The civil penalty amounts of $250 per occurrence and the $10,000 annual cap have not been increased since the section's enactment in 1988.

[74] Treas. Reg. § 301.7216-3(a).

to review an electronic copy of the return, may a consent be obtained at that time? What language constitutes sufficient notice so that a taxpayer knows (1) that he is consenting to the disclosure of information and (2) how that information will be used.

These developments in marketing and cross-marketing as well as the promotion of refund anticipation products in conjunction with electronically filed returns raise serious consumer type issues. The National Taxpayer Advocate is concerned that the IRS, in its drive to meet Congress' requirement of 80 percent electronic filing by 2007, has not sufficiently researched the consequences of some of its initiatives on tax compliance. The IRS does not have the expertise to identify issues that implicate important consumer concerns. The addition of two consumer advocates to the Electronic Tax Administration Advisory Council will provide the IRS with that expertise.

EXPLANATION OF RECOMMENDATIONS

The IRS has stated in its official response to the 2002 National Taxpayer Advocate's Annual Report to Congress that it is the domain of the States to regulate preparers independent of the Federal government. GAO has noted that regulation of return preparers has consumer protection aspects, and to that end, the Federal Trade Commission as well as state agencies have an interest in this issue. Several tax professional membership associations have advised the National Taxpayer Advocate that they would be interested in partnering with the IRS in administering a registration and testing regime.

The National Taxpayer Advocate believes that none of these circumstances are obstacles to devising a workable, cost-effective, and beneficial regime of registering, testing, and certifying Federal tax return preparers. Indeed, partnering with the Federal Trade Commission, tax professional associations, and/or the States, we will raise both the level of competency and the professionalism of return preparers.

The lack of precise data as to the scope of problems associated with tax return preparation and unenrolled return preparers, the failure to measure the effectiveness of those few preparer initiatives already underway, and the number of entities with some interest and jurisdiction over this issue have created an environment in which everyone knows something is going on, but no one entity will accept responsibility for researching and resolving the problem. It is not an adequate response to suggest that we wait until 51 different licensing jurisdictions (the 50 states and the District of Columbia) individually pass regulatory regimes.

Thus, the National Taxpayer Advocate recommends that Congress require the IRS to develop a regime that oversees the registration, education, and certification of unenrolled return prepares. Toward that end, it should require the Secretary to bring the major interested entities to the table to seriously study this issue and make recommendations. Congress should direct a Task Force, convened by the Secretary of the Treasury, to collect the data necessary to determine the scope of the problem and make recommendations about how to increase the oversight and professionalism of, and accuracy of returns prepared by, unenrolled return preparers.

This Task Force should include representatives of all interested agencies and entities. The National Taxpayer Advocate, Internal Revenue Service, Department of the Treasury, and the Federal Trade Commission should be represented on the task force, as well as State tax and consumer agencies. Nonprofit consumer protection organizations and tax professional associations, including those with large unenrolled preparer memberships, must also be members of the task force. Having everyone at the table, with all available data before them, the task force can review proposals and options for regulation and oversight of unenrolled return preparers (including the National Taxpayer Advocate's 2002 proposal) and determine the feasibility and potential impact of each.

The report of this Task Force should be delivered to Congress within one year of establishing the Task Force. The report should contain specific recommendations with regard to how to proceed and identify any Federal legislation required to implement its recommendations. The report should identify both the scope of the problem, the overlapping responsibilities of various interested parties, the means by which these responsibilities will be coordinated, and the overall regulatory approach to solving the identified problems.

Since Congress will have already directed the IRS to develop an approach to regulation and oversight of the unenrolled return preparers, the report will serve to focus the Service's efforts, obtain the viewpoints and acceptance of affected entities and preparer groups, and ensure that the issue moves along with all due haste. The National Taxpayer Advocate expects that the work of the Task Force will, in itself, bring to bear on certain undesirable practices a spotlight that will make consumers a little more careful about who they turn to when seeking tax return preparation or filing services.

Preparer Penalties

The monetary preparer penalties under Internal Revenue Code sections 6694 and 6695 have not been adjusted since 1989. The relatively low penalty amounts, in relation to the seriousness of the acts they seek to address, have two consequences. First, the IRS cannot justify using its examination and collection resources – which are subject to ever-increasing and often competing demands – to low-dollar penalties. Second, on the rare occasion that the IRS does impose a preparer penalty, the penalty amounts are so low that preparers can simply factor them in as a cost of doing business.

Raising the monetary amount of preparer penalties will increase the cost of negligence to preparers as well as increase the significance and priority of these returns for IRS compliance resource allocations. Thus, the National Taxpayer Advocate recommends the following increases in preparer penalties:

- IRC § 6694(a) preparer penalty for understatements due to unrealistic positions: increase to $1,000 from $250 per return or claim.
- IRC § 6694(b) preparer penalty for intentional disregard of the rules and regulations: increase from $1,000 to the greater of $5,000 per return or claim.
- IRC §§ 6695(a) through (e) preparer penalties relating to requirements for preparation of tax returns: increase from $50 to $100 per occurrence.
- IRC § 6695(f) for negotiation of a refund check: from $500 per check to $1,000 per check.

Unauthorized Practice and Signature Requirements

The preparation of an offer-in-compromise and taxpayer financial statements is not considered return preparation under the Code. Thus, none of the penalties under IRC §§ 6694 or 6695 apply to persons who prepare these or similar submissions for a fee.

Preparation of offers and similar submissions to the IRS does constitute practice before the IRS. Circular 230 practitioners who prepare frivolous offers or who intentionally disregard the rules and regulations are subject to Circular 230 sanctions and, if enacted, the sanctions under H.R. 1528 or S. 882. Unenrolled preparers, who are not covered by Circular 230, however, are not subject to monetary sanctions. Where an unenrolled preparer substantially completes an offer-in-compromise or a financial statement, he or she is practicing before the IRS. The Service's only recourse is to seek an injunction against the preparer under IRC § 7407.

The National Taxpayer Advocate recommends that Congress enact a $1,000 penalty for the commission of unauthorized practice before the IRS by a return preparer or other persons. The penalty would also be imposed where a return preparer or other person willfully and intentionally misrepresents his or her professional status before the IRS (including on a power of attorney authorizing him or her to represent a taxpayer before the IRS).

Circular 230 sanctions, the proposed monetary penalties in H.R. 1528 and S. 882, and the monetary penalty for unauthorized practice proposed above are not sufficient by themselves. Preparers of offers-in-compromise, financial statements, and other submissions must be required to sign these documents and supply an identification number and address, and be subject to penalties for failure to do so. We recommend that IRC § 6695 be amended to authorize the Secretary to impose a penalty of $100 per occurrence on persons who fail to sign and include certain information on specified IRS submissions prepared by them for a fee, including applications for offers-in-compromise, financial information statements, and CDP hearing requests.

Earned Income Tax Credit Penalties and Due Diligence Requirements

In addition to the penalties discussed above, we recommend that Congress amend IRC § 6695(g) to impose a tiered penalty structure on preparers who prepare EITC returns and repeatedly make negligent or intentional errors, or repeatedly fail to meet the EITC due diligence requirements. We believe this enhanced penalty structure is justified given the high error rate on EITC returns prepared by commercial preparers.

Thus, for the first occurrence of violations of IRC § 6695(g) due diligence requirements, we recommend the existing penalty of $100 per return. We recommend penalties of $500 and $1,000 per return for the second and third occurrences, respectively. Because these penalties, properly imposed, may be substantial in the aggregate, the National Taxpayer Advocate recommends that the Secretary be authorized to waive or abate the penalties, in whole or in part, where the preparer enrolls in EITC education courses and demonstrates an ability to comply with due diligence requirements.

The National Taxpayer Advocate further recommends that Congress impose a penalty, similar to the Trust Fund Recovery Penalty under IRC § 6672, against any tax return preparer who, by reason of willful and intentional misstatement, misrepresentation, fraud, or deceit, causes a taxpayer a tax liability attributable to the Earned Income Tax Credit. The EITC Recovery Penalty should be an amount equal to the tax due on the underpayment attributable to the EITC understatement assessed against the taxpayer.[75] This penalty would apply in addition to any other penalty imposed under IRC §§ 6694 and 6695, or any tax liability assessed against the taxpayer who claimed the EITC. We believe that this penalty, properly administered, will deter those persons who are attempting to game the system with respect to the EITC while not impairing the ability of EITC taxpayers to obtain qualified tax preparation assistance.[76]

[75] As with the Trust Fund Recovery Penalty, the Service would only collect the amount due. In calculating the amount of the civil penalty, Congress should authorize the Secretary, in regulations, to describe the manner in which payments will be applied where a taxpayer's payments are attributable to understatements of the other issues in addition to the EITC. It is also anticipated that the amendment would avoid the stacking of other preparer penalties to the extent there was duplication.

[76] If Congress enacts a registration, education, and certification program for unenrolled preparers, the assessment of the EITC Recovery Penalty should constitute immediate grounds for revocation of a preparer's certification. Under the National Taxpayer Advocate's 2002 proposal, taxpayers would be able to check the status of their return preparer by dialing a toll-free number or logging on to the IRS website.

As noted earlier, Treasury Regulations require an EITC return preparer to maintain a record of how and when information used to complete the EITC checklist and worksheet was obtained by the preparer. The National Taxpayer Advocate recommends that Congress amend IRC § 6695(g) to require the due diligence certification to be signed, under penalties of perjury, by the return preparer and attached to the taxpayer's income tax return.

The due diligence certification required of tax preparers should include a description of how and when the preparer obtained the information upon which he based the EITC eligibility determination (for example, from original documents, the taxpayer's statements, or from prior year's records). We also recommend that the preparer be required to certify that he or she has a system of recordkeeping for the information outlined in the regulations (including any documents or statement relied upon in making an EITC eligibility determination) and a record retention policy of three years.[77]

These requirements will make explicit the due diligence expected of EITC return preparers. Preparers who view themselves as professionals are already following these practices and should have nothing to fear from this certification. If the IRS disagrees with the position taken on the return, the preparer has the documentation to support his position, and even if his position ultimately proves incorrect, the due diligence penalty should not be imposed. Preparers who do not view themselves primarily or professionally as return preparers may have to conform their practices or risk significant, per-return penalties.[78]

These recommendations – the Due Diligence Certification filing requirement and the additional information required to be certified on that form, combined with a tiered penalty structure and an abatement alternative tied to education and improved perform-

[77] The National Taxpayer Advocate is indebted to the EITC Issue Committee of the Taxpayer Advocacy Panel (TAP) for their thoughtful and helpful suggestions about the EITC due diligence requirements. Among their suggestions, which the National Taxpayer Advocate supports, are revisions to Form 8867 that will explicitly require tax preparers to request additional information concerning eligibility, where appropriate. For example, the form can prompt preparers to inquire further: "Where the taxpayer's last tax return did not claim a qualifying child, what changes in circumstances makes the taxpayer eligible for the EITC this year?" Some TAP members also proposed that the form should, on its face, require the preparer to fill in the number of children and adults in residence in the taxpayer's household, the ages and employment status of each person, the number of rooms in the residence, and whether the qualifying child lived with the taxpayer for the requisite number of months. While some of these questions may appear overly intrusive, the TAP members justified this information request on the grounds that it requires the preparer to actually think through the EITC's eligibility requirements so that if there is a need to inquire and probe for more information, the preparer will be forced to acknowledge that, or else risk a penalty. Email from Gwen Handleman, Chair, Earned Income Tax Credit Issue Committee, Taxpayer Advocacy Panel, to Nina E. Olson, National Taxpayer Advocate.

[78] These proposals clearly shift the burden of determining EITC eligibility on to the preparer community. This issue should, of course, be openly and thoroughly considered. The National Taxpayer Advocate notes, however, that IRS EITC compliance studies have consistently demonstrated that EITC returns prepared by paid preparers are a significant source of EITC errors. Thus, there is a rational and empirical basis for additional requirements on the EITC preparer community. So long as they are aligned with "best practices" in the preparer community, diligent preparers will have no problem meeting them and should not be exposed to penalties. As an alternative to this proposal, the penalty could be equivalent to the return preparation fee, including charges for RALs and related products.

ance, along with an EITC Recovery Penalty – constitute a balanced approach to EITC preparer due diligence. The proposal will enable the IRS to conduct correspondence examinations of EITC return preparers and assess more EITC due diligence penalties, where warranted, without requiring the commitment of intensive field resources. It will also form the basis for a targeted education strategy, so that we improve the overall quality of EITC return preparation. Finally, for those preparers who persist in playing fast and loose with the EITC, we impose a substantial civil penalty to restore the EITC funds to the public fisc. Thus, IRS EITC preparer initiatives will no longer be focused on the most abusive, but will address the entire range of EITC preparer problems – from increased education to reckless behavior.

Electronic Tax Administration

The National Taxpayer Advocate acknowledges the importance of our e-file partnerships to the attainment of Congress' goal of 80 percent electronic filing of all returns by 2007. She is concerned that the absence of an intermediate sanction – between the extremes of no action or nominal action (a warning) and suspension – does not provide the proper deterrence for undesirable actions or the proper motivation to adhere to ERO Program requirements.

To address this gap, we recommend that Congress enact a $1,000 penalty imposed on Electronic Return Originators (EROs) who repeatedly fail to comply with ERO Program requirements. We also recommend that Congress impose a penalty on tax return preparers – including EROs – who:

- charge a fee for tax preparation and e-file services that is equal to a percentage of the taxpayer's refund or is based on a return item; or
- fail to advise the taxpayer of the fact that a Refund Anticipation product is a loan and the terms of that loan.

The penalty should be the greater of $100 per occurrence or 50 percent of the fee for the service. We believe that the combination of these penalties, appropriately and consistently applied, will protect taxpayers against abuses that periodically may arise in the context of electronic filing. It will also give higher priority, inside the IRS, to policing the practices of this sector.

The IRS must be cognizant that taxpayers are consumers and that failure to incorporate consumer advice and protections into its e-file programs will ultimately hamper our ability to achieve the 80 percent electronic filing goal and undermine tax compliance. For example, the IRS has not established safe harbor disclaimer language for taxpayer consents to disclosures of tax information for ancillary products and services in the e-file and other practitioner environments. To ensure that the IRS recognizes significant consumer issues, the National Taxpayer Advocate recommends that Congress require the appointment of two consumer protection advocates to the Electronic Tax Administration Advisory Committee.

Finally, the National Taxpayer Advocate remains concerned about the impact on tax administration of the entry into the e-file market of entities whose primary motivation for tax preparation or e-filing is the opportunity to sell other products or to enter into partnerships with commercial preparers in order to cross-market these products. While we have no desire to interfere with legitimate business ventures, Congress and the IRS should be concerned about these arrangements to the extent that they interfere with tax return accuracy and create oversight or compliance resource demands (in terms of downstream audits and collection efforts).

Thus, we recommend that Congress require the Secretary, in consultation with the National Taxpayer Advocate, to study the impact that cross-marketing tax preparation services with other consumer products and services has on the accuracy of returns and tax compliance, and report the results of that study to the House Committee on Ways and Means and the Senate Committee on Finance. The study should look at both taxpayer desire for and the impact of different product offerings, including the use of tax information in conjunction with tax-related financial products such as Individual Retirement Accounts and mortgage refinancings, and with nontax-related products such as furniture rentals or automobile sales. The results of this study can form the baseline for future trends studies as well as a foundation for legislation, if necessary, or compliance initiatives.

IRS RESPONSE TO NATIONAL TAXPAYER ADVOCATE'S 2002 LEGISLATIVE RECOMMENDATION:

REGULATION OF FEDERAL TAX RETURN PREPARERS

Introduction

The Internal Revenue Service is aware of and shares concerns that have been raised about the quality of the services provided by paid tax preparers. At a Senate Finance Committee hearing on April 1, 2003, the GAO said that a small percentage of the more than 71 million taxpayers that use paid preparers receive poor service because of problem performance by preparers. The National Taxpayer Advocate (NTA) also identified this issue in the 2002 NTA Report to Congress and recommended a legislative solution that would require Federal regulation of tax preparers.

The IRS views the practitioner community as a key partner in fulfilling both the service and enforcement aspects of our Mission and appreciates that the vast majority of paid preparers serve the interests of their clients and adhere to all requirements of the law. We are also concerned about the adverse impact that a minority of either unskilled or unscrupulous preparers have on taxpayers, especially individual income taxpayers claiming the Earned Income Tax Credit (EITC). Our extensive efforts to improve preparer outreach, education and oversight in this area are detailed in the IRS Comments section of the National Taxpayer Advocate's 2003 Report to Congress.

In addition to those comments, however, we also must address the specific NTA 2002 legislative proposal in light of the significant resource and responsibility implications that the proposal has for the IRS. Most of the following comments were provided to the Treasury Office of Tax Policy in early 2003 after the NTA proposal was published. We have added some important information about new actions in 2003 to increase oversight and education of preparers.

National Taxpayer Advocate's Proposal

The proposal would require the establishment of a Federal Tax Return Preparers (FTRP) program which would regulate the registration, examination and certification of any person, other than an attorney, certified public accountant or enrolled agent, who prepares more than five federal tax returns in a calendar year. These persons would have to complete the following requirements:

- Register with the IRS
- Pass an initial examination testing technical knowledge and competency
- Pass an annual refresher examination (including tax law updates) in each succeeding year
- Display his or her FTRP registration card

In addition, the legislative proposal would authorize the IRS to:

- Design, administer and certify FTRPs on an initial and annual basis
- Conduct a public information and consumer education campaign to inform taxpayers that paid preparers must sign the return and display their registration card
- Maintain a public list of registered and certified FTRPs, those who are registered but not certified and FTRPs whose registration has been revoked
- Notify applicable taxpayers that his or her return was prepared by an unenrolled return preparer who is not registered or registered but not certified

IRS Comments

The IRS believes that all taxpayers should be able to receive accurate return preparation assistance. However, while problems exist with some paid preparers, we cannot support a legislative remedy such as that proposed by the National Taxpayer Advocate.

In listing the most serious problems encountered by taxpayers, the National Taxpayer Advocate's 2002 Report to Congress said that oversight of Earned Income Tax Credit return preparers could be improved. The IRS agreed and also expressed initial support for establishing standards and procedures for registering and certifying all tax return preparers. However, this initial statement of support did not take into account many of the issues that we now are considering – issues we believe are significant enough to caution against such a legislative solution. There should be thorough consideration of these points (as outlined below), as well as more information about the scope of the problem before determining whether legislation establishing federal regulation would provide any real benefits to taxpayers.

Issues

- **Federal vs. State Role -** Historically, licensing of professionals has been within the purview of state government. Currently, the IRS regulates practice before the IRS, a representational activity that is relevant to Federal oversight. The Tax Reform Act of 1976 established the definition of and penalties on "income tax preparers" but explicitly recognized the rights of states and localities to regulate them independent of the Federal government. Only California and Oregon have established entry requirements for the field of tax return preparation. The IRS contacted these states to discuss the effectiveness of their programs. Neither state had data on the effectiveness of their program, and California specifically noted the difficulty in identifying unregistered preparers. IRS will continue this discussion with these states, because their experience could provide important information to guide future Federal action in this area.

- **Public Perception -** As early as 1953, the House Ways and Means Committee recognized that "the mere fact that a taxpayer's representative is a Treasury enrollee is no assurance of fair treatment for either the taxpayer or the Government, and that a requirement compelling all such representatives to be Treasury enrollees does not stop the unscrupulous from working undercover or through others." Despite that official notation, many taxpayers may incorrectly view the registration of a tax preparer by the IRS as an endorsement by the agency and mislead them into thinking they will get better service and somehow have recourse to the IRS should their "certified" preparers make errors or take advantage of the taxpayer.
- **Resources -** IRS does not have sufficient current resources to administer a Federal regulation of tax preparers program as outlined in the proposed legislation. Based upon the NTA's proposed program outline, we can make some assumptions on the scope of resources that might be required by looking at existing procedures that govern practice before the IRS as well as other areas that require high volume processing of information. In addition to monitoring all attorneys, certified public accountants and enrolled agents who practice before the IRS, the IRS also monitors the enrolled agent examination processes and the renewal applications for each of these individuals. Currently, there are approximately 40,000 enrolled agents. The National Taxpayer Advocate estimates that there are up to 600,000 return preparers who might be covered by the legislative proposal. Assuming the program for regulation of return preparers has at least the same if not more processing and monitoring requirements, this could entail the creation of a new mini submission processing operation with operating systems to process applications, certification, test results, etc. Significant additional resources would be required.
- **Opportunity Costs –** Given the fact that funding does not always accompany legislative requirements, IRS would be faced with redeploying resources from other programs, which could have a negative impact on current enforcement, service improvement and revenue collection efforts.
- **Enforcement -** Without civil penalties or criminal sanctions for failure to register, it is likely that many of these preparers will simply ignore these provisions and continue their business. Many could go underground (making their detection extremely difficult) offering their services at a lower cost, not signing tax forms and evading any subsequent enforcement activities. This would make IRS enforcement that much more difficult and resource intensive.

- **Added Taxpayer Cost –** While it has been suggested that the primary cost of registration would be borne by the tax preparers, we believe businesses typically raise their fees to cover increased costs. Therefore, the cost of this program would likely be passed on to the taxpayer. This can have an unintended consequence of increasing the cost burden to the taxpayer without providing them any assurance that they are buying better or more accurate return preparation services.

Alternatives to Legislation Requiring Federal Regulation

The IRS believes there are productive alternatives to additional legislation requiring more Federal oversight. In addition the specific EITC related activities detailed in the NTA 2003 Report, IRS has taken a number of steps to increase oversight of practitioners and to improve educational outreach.

- Increasing Oversight of Practitioners – IRS has created a top-level executive office, the Office of Professional Responsibility (OPR), that reports directly to the Deputy Commissioner Services and Enforcement. This office will ensure that a unified strategy for improving confidence in the integrity of tax professionals is developed and implemented.
- To establish a clear understanding of what are the expected professional standards for tax professionals, OPR will take the following actions throughout 2004.
  - Release a priority list of best practices to be encouraged, as well as improper or unethical practices to be deterred.
  - Continue to get input from the tax preparer community about their views on regulation and registration.
  - Identify additional statutory and regulatory authorities that would be needed to modify practitioner behaviors.

To ensure that IRS employees know what tools are already available to them to address undesirable practitioner behaviors, OPR will provide a complete inventory of tools currently available and how to apply them. Paid return preparers are currently subject to criminal and civil penalties for a wide range of inappropriate behavior. Criminal penalties may be asserted for willfully attempting to evade tax, willfully making false statements under penalties of perjury, and willfully aiding, assisting, counseling or advising in the preparation of any document in connection with the Internal Revenue laws that is false or fraudulent. Civil penalties may be asserted for willfully attempting to understate the tax liability of another person, or if the preparer negotiates a check issued with respect to another person's taxes. Preparers are also subject to civil penalties for failing to (1) sign a return, (2) furnish their identifying number, (3) file a correct information return, (4) furnish the taxpayer with a copy of a return, (5) retain a copy of a return, or (6) be diligent in determining a taxpayer's eligibility for the Earned Income Tax Credit. By educating IRS employees on the full range of tools already available to them to identify these behaviors, the IRS believes that compliance will be strengthened.

- Education – The IRS is expanding preparer education activities through continuing professional education programs, on-line courses and tax forums. One of the Service's most effective outreach programs to the tax professional community is the IRS Nationwide Tax Forums. These forums include seminars and trade shows and offers information on tax law changes, how to save time by e-filing, ethics and how to become an Electronic Return Originator. This year, there were also advanced sessions focusing on abusive schemes, tax shelter reporting and compliance, and refund crimes. Additionally, through Tax Preparer Institutes, the IRS continues to provide materials on high priority programs to educational institutions.
- Outreach – The IRS is increasing publicity on how to choose an income tax return preparer. The agency is working with the American Bar Association to further expand and publicize criteria for choosing a tax preparer. In addition, recent Criminal Investigation press releases have highlighted instances of fraud among tax return preparers. Both the ABA's web site and IRS press releases reference such criteria as avoiding anyone that bases fees on a percentage of the refund, refuses to sign the return, claims to know a special or secret way to avoid taxes, suggests taking unsubstantiated deductions and credits, asks customers to sign blank returns, or asks for the refund to be mailed directly back to them. Additionally, IRS envisions including reliable preparer criteria on irs.gov, in the IRS e-news subscription service, and in future filing season press releases. Also, information can be included in IRS partnership outreach efforts with local community organizations that sponsor programs designed to enhance tax and financial literacy.
- Testing - The IRS recognizes that it faces a particular challenge in getting information to and identifying the needs of unenrolled tax return preparers. A current effort will test the effect of education materials on those preparers who prepare Earned Income Tax Credit (EITC) returns and may provide a model of how to meet this challenge. The test centers on providing an educational brochure to three groups of EITC preparers and then compares their subsequent rate of errors over three years to groups with similar characteristics who did not get the brochure. The brochure, with a desired outcome of reducing errors and improving EITC compli-

ance, includes material on tax law changes, due diligence and information on where to get further EITC information.

Conclusion

The IRS believes that all taxpayers should be able to receive accurate return preparation assistance and shares the Advocate's concern about the minority of preparers who do not serve their clients, our taxpayers, well. However, without knowing the full extent of the problem, whether the proposed legislative remedy would bring about the desired result and the impact on IRS resources, it is premature to consider a legislative solution. The IRS will continue to work with the National Taxpayer Advocate to define the nature and scope of the problem and carefully assess the impact of actions taken by the new Office of Professional Responsibility and our enhanced outreach and oversight efforts in the EITC arena.

4 FILING DUE DATE OF PARTNERSHIPS AND CERTAIN TRUSTS

PROBLEM STATEMENT

S corporations, partnerships and certain trusts are often referred to as "pass-through" entities. In general, this means that the income, deductions and other tax attributes of the entities "pass through" to their owners, and the owners include their allocated shares of income on their individual income tax returns. Pass-through entities issue separate schedules (Schedules K-1) to each of their owners to report the amount of income and other items that must be included on the owner's individual tax return. For a taxpayer to be able to file his or her individual tax return by the April 15 filing deadline (i.e., without requesting a filing extension), the taxpayer generally must receive Schedule K-1 sufficiently in advance to include the relevant information on his or her tax return.

In practice, however, Schedules K-1 often do not arrive in time for the individual taxpayer to avoid requesting an extension to file his or her own return. Schedules K-1 generally cannot be prepared until the entity-level tax return is completed. While S corporations face a filing deadline of March 15, most partnerships and trusts are not required to file their returns until April 15th. Accordingly, many partnerships and trusts do not issue Schedules K-1 to their owners until about April 15, requiring a significant number of taxpayers each year to request extensions. In some cases, these taxpayers may also be subject to penalties for failure to pay required estimated taxes.[1]

EXAMPLE

A taxpayer is a partner in a calendar-year partnership with an April 15 filing deadline. He knows from past experience that the partnership will not get around to filing its return and issuing Schedules K-1 to its partners until about April 15. Accordingly, he files Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Income Tax Return) to request a filing extension until August 15. On April 16, the taxpayer receives his K-1 for the prior year. He discovers that he has a large, unexpected capital gain allocation. He did not plan for this allocation and therefore did not estimate his taxes correctly. As a result, not only will he be required to pay the tax attributable to the capital gains allocation, but he will be liable for the failure to pay an addition to tax and interest on the amount of the tax due from April 15 through the date on which the tax is paid.[2] Depending upon the amount of the underpayment, he may also owe an estimated tax penalty because of his insufficient prepayments.[3]

[1] Estates also issue Schedules K-1. See IRC § 6034A; Form 1041 (U.S. Income Tax Return for Estates and Trusts), which includes Schedule K-1 (Beneficiary's Share of Income, Deductions, Credits, etc.). However, the due date of estate tax returns is based on the date of death of the decedent. IRC § 6075(a). Therefore, Schedules K-1 issued by estates do not present the same problems as those issued by calendar-year pass-through entities.

[2] IRC §§ 6651(a)(2) and 6601.

[3] IRC § 6654.

RECOMMENDATION

Amend Internal Revenue Code section 6072(a) to change the regular filing deadline for partnerships described in Section 6031 and trusts described in Section 6012(a)(4) as follows:

- For partnerships and trusts making returns on the basis of a calendar year: Change the regular filing deadline from the 15th day of April following the close of the calendar year to the 15th day of March following the close of the calendar year.
- For partnerships and trusts making returns on the basis of a fiscal year: Change the regular filing deadline from the 15th day of the fourth month following the close of the fiscal year to the 15th day of the third month following the close of the fiscal year.[4]

PRESENT LAW

There are three main types of entities whose income and other tax attributes flow through to their owners: S corporations, partnerships and trusts. The shareholder, partner, or beneficiary, respectively, is required to report this income on Form 1040, Schedule E (Supplemental Income and Loss).

The due date for Form 1040 and its schedules is the 15th day of the fourth month following the close of the taxable year.[5] For most individual taxpayers, this means April 15, although an automatic four-month extension will be granted if requested on or before the due date of the return.[6] If a taxpayer needs additional time, he or she must file Form 2688 (Application for Additional Extension of Time to File U.S. Individual Tax Return) by the extended due date.[7]

S CORPORATIONS

The filing deadline for all corporations, including S corporations,[8] is the 15th day of the third month following the close of the corporation's tax year.[9] The S corporation's return

[4] Internal Revenue Code section 6031(b) provides generally that a partnership required to file a return must furnish information statements to the partners "on or before the day on which the return for such taxable year was required to be filed." IRC § 6034A provides that the fiduciary of an estate or trust required to file a return under IRC § 6012(a) must furnish information statements to the beneficiaries (or nominees thereof) "on or before the date on which such return was required to be filed." Therefore, a change in the due date of the partnership and trust returns would automatically change the date by which partnerships and trusts would be required to furnish information statements to partners and beneficiaries.

[5] Treas. Reg. § 1.6072-1(a).

[6] Treas. Reg. § 1.6081-4(a).

[7] Treas. Reg. § 1.6081-1(b)(5). This form requires a detailed explanation of the need for additional time.

[8] Generally speaking, an S corporation is a small business corporation that does not have more than 75 shareholders, does not have corporate shareholders, does not have nonresident aliens as shareholders, and does not have more than one class of stock. IRC § 1361(b)(1). The corporation must make an election to be taxed as an S corporation and all of its shareholders must consent. IRC § 1362(a). The principal reason to make an S election is generally to avoid the corporate-level tax. See IRC § 1363(a).

[9] IRC § 6072(b); Treas. Reg. § 1.6037-1(b).

must be filed on Form 1120S (U.S. Income Tax Return for an S Corporation), which includes Schedule K-1 (Shareholder's Share of Income, Credits, Deductions, etc.).[10]

A corporation shall be allowed an automatic six-month extension by meeting the following requirements:

- An application must be prepared on Form 7004 (Application for Automatic Extension of Time to File Corporation Income Tax Return) and be signed by a person authorized to request such an extension.
- The application must be filed on or before the date prescribed for filing the corporation's return with the IRS officer with whom the corporation is required to file.[11]

Partnerships

The filing deadline for partnerships is the 15th day of the fourth month following the close of the tax year of the partnership.[12] The partnership's return must be filed on Form 1065 (U.S. Partnership Return of Income), which includes Schedule K-1 (Partner's Share of Income, Credits, Deductions, etc.). For a calendar year partnership, therefore, the due date is April 15 – the same due date as for individual taxpayers. At present, 98.6 percent of all partnerships operate on a calendar-year basis and have an April 15 due date.[13]

A partnership is entitled to an automatic three-month extension of time to file Form 1065 if it files Form 8736 (Application for Automatic Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts).[14] However, this extension does not extend the time for filing a partner's individual tax return or the time for payment of any tax due on that return.[15] If the partnership requires additional time beyond the automatic extension, it must file Form 8800 (Application for Additional Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts). This form requires a detailed explanation of the need for additional time.

Trusts

The filing deadline for trusts is generally the 15th day of the fourth month following the close of the trust's taxable year.[16] The trust return must be filed on Form 1041 (U.S. Income Tax Return for Estates and Trusts), which includes Schedule K-1 (Beneficiary's Share of Income, Deductions, Credits, etc.).[17] For a calendar year trust, therefore, the due date is April 15 – the same due date as for individual taxpayers. A trust is allowed an

[10] See Treas. Reg. § 1.6037-1(a).

[11] Treas. Reg. § 1.6081-3(a).

[12] IRC § 6072(a) (cross referencing IRC § 6031); Treas. Reg. § 1.6031(a)-1(e)(2).

[13] Tax Year 2001, Compliance Research Information System (CRIS), BFM Model (2002).

[14] Treas. Reg. § 1.6081-2(a) & (b).

[15] Treas. Reg. § 1.6081-2(e).

[16] IRC § 6072(a) (cross referencing IRC § 6012); Treas. Reg. § 1.6072-1(a)(1).

[17] Treas. Reg. § 1.6012-3(a).

automatic three-month extension by filing Form 8736 (Application for Automatic Extension of Time to File U.S. Return for a Partnership, REMIC or for Certain Trusts).[18] The automatic extension of the trust return filing deadline does not serve to extend the income tax return filing deadline for the beneficiaries.[19]

In certain circumstances, these filing requirements do not apply to grantor trusts. Under the grantor trust rules, a person who transfers property to a trust but retains certain powers or interests is treated as the owner of the trust for federal income tax purposes.[20] When certain criteria are met, a grantor trust has no Form 1041 filing requirement (and therefore has no requirement to issue the associated Schedules K-1).[21]

REASONS FOR CHANGE

The Internal Revenue Code generally requires individual taxpayers to file their income tax returns by April 15 for the preceding calendar year. To comply with this deadline, taxpayers obviously need complete information about their income. Payors generally are required to furnish information statements (e.g., Forms W-2 and Forms 1099) by January 31. Although approximately 6.4 million taxpayers reported income from a Schedule K-1 (Partner's Share of Income, Credits, Deductions, etc.) in 2001, there is no requirement that the Schedule K-1 be issued prior to April 15.

Thus, it is hardly surprising that taxpayers receiving Forms K-1 are about five times more likely to request filing extensions than other taxpayers. Of the 6.4 million taxpayers reporting income from a Schedule K-1 (Partner's Share of Income, Credits, Deductions, etc.) in 2001, 27.5 percent (1.7 million) requested an extension of time to file.[22] This compares to 5.5 percent (4.2 million) of taxpayers who requested an extension out of 78 million taxpayers who filed Form 1040 without a Schedule K-1.[23] Although comparable data for trusts was not available, the number of Schedules K-1 issued by trusts is substantially lower than the number of Schedules K-1 issued by partnerships.[24]

Large numbers of extension requests are problematic for both taxpayers and the IRS. From the taxpayer's perspective, the preparation of extension requests is time-consuming and costly. The IRS estimates that it takes 67 minutes to request a four-month extension

[18] Treas. Reg. § 1.6081-6(a) & (b).

[19] Treas. Reg. § 1.6081-6(c).

[20] See IRC § 671; Treas. Reg. § 1.671-2.

[21] See Treas. Reg. § 1.671-4.

[22] Tax Year 2001, Compliance Research Information System (CRIS), BFM Model (2002).

[23] Tax Year 2001, Compliance Research Information System (CRIS), BFM Model (2002).

[24] For tax year 2001, there were approximately 3.9 million trust returns filed, with approximately four million associated Schedules K-1. During the same time period, there were approximately 2.16 million partnership returns filed, with approximately 16 million associated Schedules K-1. See Projections of Returns To Be Filed in Calendar Years 2002-2009, SOI Bulletin, Winter (2002-2003), and Calendar Year Projections of Information and Withholding Documents for the United States and IRS Centers: 2002-2010, Document 6961 (Rev. 6-02), Table 2.

and 46 minutes to request an additional two-month extension.[25] There were a total of 1.7 million taxpayers who filed a Form 1040 reporting partnership K-1 income that requested extensions of time to file in 2001.[26] If all of these taxpayers prepared the four-month extension request themselves, it would have taken them 1.9 million hours collectively.[27] However, only 15 percent of these taxpayers personally undertook the task of preparing the required forms. The remaining 85 percent paid return preparers to do it.[28] When a taxpayer is required to file for an extension, the taxpayer is unable to quickly finalize his or her tax obligations for the preceding tax year, and this reasonably heightens frustration with the complexity of the tax system.[29]

From the IRS's perspective, the processing of extension requests consumes resources. Based on a recent report issued by the Treasury Inspector General for Tax Administration, the cost of processing 1.7 million extensions is approximately $1.1 million.[30] If fewer taxpayers were required to file for extensions because they received their Schedules K-1 in sufficient time to file by April 15, the IRS could re-direct its resources to other programs.

There are currently approximately 2.16 million partnerships, and approximately 75 percent of them file their returns by the April 15 filing deadline.[31] Therefore, this proposal could potentially impact 1.6 million partnerships.

EXPLANATION OF RECOMMENDATIONS

The National Taxpayer Advocate recommends that the filing date for partnerships and trusts be changed from the 15th day of the fourth month following the close of the tax year to the 15th day of the third month following the close of the tax year. This would put partnerships and trusts on a par with S corporations, so that all calendar-year pass-through entities that issue Schedules K-1 to their owners have a March 15 filing deadline (except estates).[32]

[25] Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Income Tax Return), p. 4; Form 2688 (Application for Additional Extension of Time to File U.S. Individual Income Tax Return), p. 2.

[26] Tax Year 2001, Compliance Research Information System (CRIS), BFM Model (2002).

[27] Time estimate computed from data contained in footnotes 24 and 25.

[28] Tax Year 2001, Compliance Research Information System (CRIS), BFM Model (2002).

[29] The National Taxpayer Advocate believes this estimate significantly understates the amount of time required to prepare an extension, since the taxpayer must, in essence, complete a rough draft of his or her return in order to properly complete the extension request.

[30] In a recent audit report, TIGTA estimated that the cost of processing 9.7 million requests for extension of time to file was $6.3 million. See The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers, TIGTA Audit Report 200330162 (Aug. 2003). By extrapolation, the approximate cost to process 1.7 million requests for extension would be $1.1 million.

[31] Tax Year 2001, Compliance Research Information System (CRIS), BFM Model (2002).

[32] Estates are excluded from this proposal because very few estates file returns on a calendar-year basis. The due date of an estate tax return is based on the date of death of the decedent. IRC § 6075(a).

We believe that this proposal will substantially increase the number of taxpayers who receive Schedules K-1 in sufficient time to enable them to file their tax returns by the regular April 15 deadline.[33] Where the taxpayer's return is so complicated as to require additional time to file, the taxpayer will at least be able to more accurately compute his estimated tax liability and make proper payment with his extension request, thereby avoiding late-payment penalties and interest.

[33] In developing this recommendation, we consulted with representatives of several groups that represent professional tax preparers. The majority of those consulted was supportive of this recommendation, but several expressed concern that entities with particularly complex financial and/or tax situations might find the March 15 deadline difficult or impossible to meet. As described in the Present Law section above, S corporations, partnerships, and trusts may obtain filing extensions under existing law. Therefore, this recommendation should not unduly burden entities, or their representatives, who have difficulty meeting the March 15 deadline. Any entity that could not complete its return by March 15 could simply request an extension of the due date.

5 ATTAINMENT OF AGE DEFINITION

PROBLEM

Although most people believe that they attain their next age on their birthday (the "birthday rule"), English common law holds that individuals "attain" their next age on the day preceding their birthday (the "common law rule"). This distinction has tax significance for individuals with January 1st birthdays, because under the common law rule, these individuals attain their next age on December 31st – the preceding tax year.

At least 75 Code sections refer to the attainment of an age in one or more places. Several of these sections are now obsolete. Many merely have a one-day effect, that is, the taxpayer must do something a day earlier or a day later, or the taxpayer will gain or lose a deduction for one day. Sometimes the difference is a month rather than a day. In other instances, however, the provisions affect the taxpayer for the entire year. For example, under the common law rule, the taxpayer loses the Child Tax Credit, the Earned Income Tax Credit, the personal exemption for a child, and the dependent care credit if the child's disqualifying birthday falls on January 1st of the year following the tax year in question. The dollar amounts associated with these provisions are significant.

EXAMPLE

A married taxpayer has a daughter who is his dependent for tax years 2002 and 2003. The daughter's 19th birthday falls on January 1, 2003. For tax year 2001, the taxpayer was eligible for an Earned Income Tax Credit under IRC § 32 in the amount of $2,000, attributable to his daughter being a "qualifying child." Under the common law rule, the daughter turned 19 on December 31, 2002, and consequently was not a "qualifying child" for purposes of the Earned Income Tax Credit for tax year 2002, despite her actual 19th birthday being January 1, 2003.

RECOMMENDATION

Amend Internal Revenue Service Code section 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."

PRESENT LAW

Origin of the "Common Law" Rule

It is believed that the common law rule holding that a person "attains the age of xx" on the day preceding his or her birthday dates back to 17th century England. In 1677, the court of common pleas stated:

> So in a devise the question was, whether the testator was of age or not? And the evidence was, that he was born the first day of January in the afternoon of that day, and died in the morning on the last day of December: and it was held by all the Judges that he was of full age; for there shall be no fraction of a day.[1]

Courts in England and the United States have generally held that an individual attains an age the first moment of the day before the anniversary of the individual's birth.[2]

Both the Social Security Administration and the Centers for Medicare and Medicaid Services use the day-before rule.[3] Thus, an individual is entitled to benefits beginning with month in which he attains a stated age. If his birthday is on the 1st day of the month, he is entitled to benefits beginning with the previous month. On the other hand, where a child of a deceased worker has a birthday that falls on the 1st day of the month, his benefits will cease in the month preceding that day.

Internal Revenue Code

Over 70 Internal Revenue Code sections contain language such as "attain the age of xx."[4] The first instance this phrase was used in the Internal Revenue Code appears to be in the Revenue Act of 1948 in connection with a new provision granting older persons an extra personal exemption.[5] The legislative history of this provision states:

> For purposes of the old-age exemption, an individual attains the age of 65 on the first moment of the day preceding his sixty-fifth birthday. Accordingly, an individual whose sixty-fifth birthday falls on January 1 in a given year attains the age of 65 on the last day of the calendar year immediately preceding.[6]

[1] Nichols v. Ramsel (1677) 2 Mod 280, 86 Eng Reprint 1072.

[2] For a thorough discussion of the common law rule, see R.F. Martin, Annotation, Inclusion or Exclusion of the Day of Birth in Computing One's Age, 5 A.L.R.2d 1143 (1949).

[3] 20 CFR 404.2(c) (pertaining to Social Security benefits) states: "(4) Attainment of age. An individual attains a given age on the first moment of the day preceding the anniversary of his birth corresponding to such age."

[4] Included in these provisions are a few sections that deal with alcohol taxes and with Tax Court personnel matters. This recommendation does not address these provisions.

[5] IRC § 25(b)(1)(B) (1939 Code) (the predecessor of former section 151(c) of the 1954 Code, which is the predecessor of section 63(f)(1) (dealing with the definition of "taxable income")).

[6] S. Rep. No. 1013, 80th Cong., 2d Sess. 49 (1948); H.R. Rep. No. 1274, 80th Cong., 2d Sess. 43 (1948).

The statutory language was re-enacted in the 1954 Code as section 151(c). Implementing regulations issued in 1957 applied the common law rule in determining the taxpayer's age, but did not apply it to determining the age of the taxpayer's child.[7] Applying the common law to the taxpayer's age was beneficial to the taxpayer; its application to the taxpayer's child's age would not have benefited the taxpayer.

The IRS has subsequently applied the common law rule to other provisions that benefited the taxpayer, including the credit for the elderly[8] and the sale of a principal residence by an individual who has attained age 55 (now obsolete).[9] More recently, in the instructions for Form 8615, the Service applied the common law rule to the child's age for purposes of the "kiddie tax" on unearned income of minor children under IRC § 1(g).

REASONS FOR CHANGE

In preparation for the 2002 filing season (which occurred January – April of 2003), the IRS reversed its longstanding practice of utilizing the birthday rule for purposes of most key Code sections and imposed the common law rule instead. The Service did this by using consistent language throughout its tax forms and publications and by programming the common law rule into its software for purposes of the IRA catch-up contributions, the saver's credit, the child tax credit (CTC), and the Earned Income Tax Credit (EITC). The IRS also provided software providers with the information necessary to make changes to their software.

The common law rule is favorable to the taxpayer with respect to IRA catch-up contributions and the saver's credit; it is not favorable to the taxpayer with respect to the CTC and the EITC. Thus, taxpayers whose child's 17th birthday was on January 1, 2003, lost the CTC, and taxpayers whose child's 19th birthday was on January 1, 2003, generally lost the EITC.[10]

[7] *See* Treas. Reg. § 1.151-1(c)(2) (1957).

[8] Rev. Rul. 69-422, 1969-2 C.B. 1.

[9] Rev. Rul. 77-382, 1977-2 C.B. 51.

[10] Many taxpayers in this situation were preventing from claiming the CTC and/or the EITC by their software program. Where programs did not block these claims, the IRS treated these claims as math error procedures.

This change from the birthday rule to the common law rule for the CTC and the EITC had an adverse impact on thousands of taxpayers during the 2003 filing season. After several taxpayers contacted the Taxpayer Advocate Service (TAS) for assistance, we raised the issue with the IRS and the Department of the Treasury. The IRS ultimately issued a revenue ruling adopting the birthday rule for purposes of eight provisions of the Code.[11]

While the revenue ruling provides a partial solution to the problem, as noted above, the IRS Office of Chief Counsel has identified approximately 70 provisions for which eligibility turns, in part, on whether an individual has "attained" a certain age, and the IRS continues to apply the birthday rule for purposes of some provisions and the common law rule for purposes of others. As a result, if either a taxpayer or an individual claimed on a return has a January 1st birthday, the taxpayer often must determine on a provision-by-provision basis whether the requirements of the provision are satisfied. In most cases, the birthday rule benefits the taxpayer; in some cases, the common law rule is more advantageous.

EXPLANATION OF RECOMMENDATION

The National Taxpayer Advocate recommends that IRC § 7701 be amended by adding a new subsection that provides that an individual attains a particular age on the anniversary of that individual's date of birth. This rule – the "birthday rule" – is far more intuitive and more generally accepted by the taxpaying public than the common law rule. Where Congress determines that it is beneficial for an individual's age to be determined under the common law rule with respect to a particular code provision, that section can specify thus, notwithstanding IRC § 7701. In these instances, Congress' intent will be clear. Further, since this approach has the benefit of being in accordance with common parlance, taxpayers who are not tax experts will not be harmed if they interpret the phrase in the generally accepted manner

[11] Rev. Rul. 2003-72 The eight provisions are: dependent care credit (IRC § 21), adoption credit (IRC § 23), child tax credit (IRC § 24), earned income tax credit (IRC § 32), dependent care assistance programs (IRC § 129), foster care payments (IRC § 131), adoption assistance programs (IRC § 137), and dependency exemptions (IRC § 151). Each of these provisions permits the taxpayer to claim a credit, exclusion, or deduction if, among other requirements, a child has not attained a particular age. In December 2003 the IRS sent out notices to taxpayers it had systemically identified as being harmed by the CTC and EITC changes for tax year 2002, suggesting that they file amended returns in order to claim either credit, if otherwise eligible (i.e., the IRS reversed its stance on the meaning of "attainment of age" to apply the birthday rule for the 2003 filing season retroactively).

MOST LITIGATED ISSUES INTRODUCTION

Internal Revenue Code section 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate's Annual Report to Congress to identify the 10 tax issues most often litigated in the Federal courts, and to classify those issues by the type of taxpayer affected. Through analysis of these issues, the National Taxpayer Advocate will, if appropriate, make recommendations designed to mitigate disputes that result in litigation. We recognize that many taxpayers litigate issues because of legitimate, interpretative, and factual disputes of law. However, the recommendations included in some of our discussions could eliminate or minimize some of the litigation covered in this section.[1]

The Taxpayer Advocate Service worked with the Office of Chief Counsel to identify the issues most frequently litigated. Our office researched a commercial database for decisions filed for each issue by the United States Tax Court, the Federal district courts, the United States Court of Federal Claims and the United States bankruptcy courts during the period of June 1, 2002 through May 31, 2003. For this analysis and report, the term "litigated" is defined as a case with a published decision by the court. This does not mean that the taxpayer has exhausted the appeals process.

In 2002, we expanded the Most Litigated Issues section of this report, with the analysis of the cases tried becoming more detailed and comprehensive than in any previous Annual Report to Congress. Our goal for 2003 was to improve our reporting of the most litigated issues, and we did so by the addition of a "Summary" section for each issue analyzed and reported on. The "Summary" provides the reader a synopsis of the detailed analysis. A detailed analysis follows and includes a description of the current law, a breakdown of cases litigated, and a conclusion. Recommendations for specific Legislative and/or administrative changes are incorporated in the conclusions, as appropriate.

We have also listed each of the cases litigated, by issue, in Appendix 2 of this report and have categorized the cases by type of taxpayer. The case listings for each issue identify the taxpayer's name, the specific citation of the case, the court in which it was tried, a brief synopsis of the issue, whether the taxpayer was represented at trial by counsel or argued the case *pro se*, and the decision of the court. The "decision" of the court is identified as a decision for the taxpayer, for the IRS, or as a split decision. For purposes of this analysis, only the issue analyzed was considered when identifying the decision of the court. A split decision was defined as a partial allowance of the specific issue litigated.

[1] *See, e.g.*, Collection Due Process, Income Issues, and Earned Income Tax Credit infra.

AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

Taxpayers generally have access to four different tribunals in which to litigate a tax matter – the United States Tax Court, the federal district courts, the United States Court of Federal Claims, and the U.S. bankruptcy courts. Each of these courts has specific jurisdiction over certain types of tax cases.

The United States Tax Court is generally a "pre-payment" forum and has jurisdiction over deficiency cases,[2] declaratory judgments,[3] lien and levy cases,[4] and other matters that are conferred on the court from time to time by statute.[5] Both the federal district courts and the Court of Federal Claims are "refund fora."[6] They have jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,[7] and (2) the taxpayer has filed an administrative claim for refund.[8] The federal district courts are the only forums in which a taxpayer can receive a jury trial. Bankruptcy courts can adjudicate tax matters that involve a debtor's open tax years and were not previously adjudicated before the initiation of a bankruptcy case.[9]

Each of the courts has specific rules regarding procedures and evidence. The Tax Court and U.S. Court of Federal Claims are national courts; the Tax Court holds trial calendars in 62 cities.[10] The federal district and bankruptcy courts, on the other hand, are local courts, sitting in judicial districts throughout the nation.

The taxpayer's choice of judicial forum depends on many factors, including the court's procedures, the burden of proof, and the controlling precedent. As noted above, if the Tax Court has subject matter jurisdiction over the taxpayer's case, he or she can litigate without paying the tax in advance but must file the petition within the prescribed 90 days from the date of the Notice of Deficiency.[11]

ANALYSIS OF *PRO SE* LITIGATION

Again this year our analysis indicated that many taxpayers represented themselves before the court, *pro se*.[12] The following table (Table Intro-01) lists the most litigated tax issues

[2] *See* IRC § 6214.

[3] *See, e.g.*, IRC §§ 7428(a), 7476, 7477, 7478, 7479.

[4] IRC § 6330(d).

[5] IRC § 7442.

[6] 28 U.S.C. § 1346(a)(1).

[7] *See* Flora v. United States, 362 U.S. 145 (1960).

[8] IRC § 7422(a).

[9] *See* 11 U.S.C. §§ 505(a)(1) and (a)(2)(A).

[10] The Tax Court holds trial sessions in 15 additional cities for cases involving up to $50,000 in dispute per tax year.

[11] IRC § 6213(a). A petitioner who is outside of the United States at the time the Notice of Deficiency is mailed has 150 days within which to file a petition with the Tax Court.

[12] "*Pro Se*" means "for oneself; on one's own behalf; without a lawyer." *Black's Law Dictionary* 1236-37 (7th ed. 1999).

for the period June 1, 2002, through May 31, 2003, and identifies the number of cases in which taxpayers represented themselves before the court.

TABLE INTRO-01

MOST LITIGATED ISSUE	TOTAL NUMBER OF LITIGATED CASES REVIEWED	*PRO SE* LITIGATION	PERCENTAGE OF PRO SE CASES
Abusive Trusts	17	9	53%
Activity Not Engaged in for Profit	14	8	57%
Collection Due Process	199	175	88%
Itemized Charitable Contributions	21	18	86%
Earned Income Tax Credit	31	24	77%
Failure to File Penalty	31	26	84%
Income Issues	175	94	54%
Interest Deductions	12	4	13%
Accuracy-Related Penalty for Negligence	41	25	61%
Trade or Business Expenses	55	24	44%
Total	**596**	**407**	**68% Overall**

In all but two of the most litigated issues, 50 percent or more of the cases were tried *pro se*. Collection Due Process (CDP), Charitable Contributions, EITC, and Failure to File Penalty all reflect substantially high percentages of cases tried without legal representation for the taxpayer. Of the 407 *pro se* cases litigated, 72 percent (293 cases) were tried in United States Tax Court.

Table Intro-02 illustrates the number and percentage of cases where *pro se* and represented taxpayers prevailed in each of the issues considered by the courts.

TABLE INTRO-02

	Pro Se Taxpayers			Represented Taxpayers		
Most Litigated Issue	Total Cases	Taxpayer Prevailed	Percent	Total Cases	Taxpayer Prevailed	Percent
Abusive Trusts	9	0	0%	8	0	0%
Activity not Engaged in for Profit	8	1	13%	6	1	17%
Collection Due Process	175	0	0%	24	1	4%
Itemized Charitable Contributions	18	1	6%	3	0	0%
Earned Income Tax Credit	24	3	13%	7	0	0%
Failure to File Penalty	26	1	4%	5	0	0%
Income Issues	94	2	2%	81	12	15%
Interest Deductions	4	0	0%	8	1	13%
Accuracy-Related Penalty for Negligence	25	1	4%	16	3	19%
Trade or Business Expenses	24	3	13%	31	3	10%
Totals	**407**	**12**	**3%**	**189**	**21**	**11%**

CONCLUSION

Analysis has shown that the number of taxpayers handling their own cases regarding the ten most litigated tax issues has risen 17 percent from the previous year.[13] An even greater concern is the fact that, for the second year in a row, this analysis indicates that taxpayers who represent themselves are less likely to prevail in court than those taxpayers who obtain representation. Table Intro-02 shows that taxpayers who represent themselves prevailed in only three percent of the cases tried, where taxpayers with representation before the court prevailed in 10 percent of the cases litigated.

Again this year we encourage the courts, the Internal Revenue Service, legal and tax professional associations and Congress to join the National Taxpayer Advocate in protecting the rights of all taxpayers who dispute tax matters. Even more importantly, it should be our charge to take special care in ensuring that the rights of *pro se* taxpayers in litigation with are not dismissed simply due to the fact that the taxpayer has no legal counsel.

[13] National Taxpayer Advocate, *Annual Report to Congress,* Publication 2104 (Rev. 12-2002) p. 256.

LITIGATED

ISSUE #1 **MOST LITIGATED ISSUE: COLLECTION DUE PROCESS (CDP)**

SUMMARY

The Collection Due Process hearing, established by the IRS Restructuring and Reform Act of 1998, provides taxpayers an opportunity for independent review of a lien filed by the IRS or a proposed levy action.[1] The taxpayer may raise certain issues at the hearing, including the appropriateness of collection actions, collection alternatives, spousal defenses, and under certain limited circumstances, the underlying tax liability.

Collection Due Process was the most frequently litigated issue in the federal courts during the period reviewed for the Annual Report to Congress, with the number of cases more than doubling from the previous year. The decisions reflect a significant increase in cases decided for IRS, and a decrease in dismissed cases. Eighty-eight percent of the CDP cases were brought before the courts by the taxpayer without the benefit of counsel (i.e., *pro se*), up from 70 percent in the previous year.

The courts ruled on many procedural issues, including what types of issues can be raised at hearings, what an 'opportunity for hearing' means, questions of jurisdiction, the type of hearing held (i.e., face-to-face, telephonic), whether a hearing is even required, and whether a hearing may be recorded.

The analysis revealed that in 52 percent of the litigated cases, taxpayers presented frivolous arguments. Legislation pending before Congress would authorize an increase in the penalties for frivolous submissions and/or permit the IRS to reject frivolous submissions, including frivolous CDP hearing requests. While there is a need to reduce the number of frivolous submissions, the National Taxpayer Advocate believes the IRS should proceed with caution in making the "frivolous" identification. Without the appropriate safeguards, legitimate but poorly developed CDP requests could be improperly classified as "frivolous."

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of a lien[2] filed by the IRS or a proposed levy action.[3] The IRS Restructuring and Reform Act of 1998 "RRA 98" established the Collection Due Process hearing to ensure lien and/or proposed levy actions are both warranted and procedurally correct.[4]

[1] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3401, 112 Stat. 685.

[2] IRC § 6320.

[3] IRC § 6330.

[4] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3401, 112 Stat. 685.

The IRS sends by certified or registered mail a notice to the taxpayer's last known address, giving him or her the opportunity to request a CDP hearing.[5] The taxpayer must return a signed, written request for a hearing within thirty days of the date of notice.[6] Unless the IRS has reason to believe collection of the tax is in jeopardy, the IRS will stop levy action during the 30-day period.[7]

When a taxpayer requests CDP hearings for both a lien and a proposed levy, the Appeals Officer will conduct one hearing.[8] If the taxpayer's appeal is filed on time, the IRS will suspend collection action throughout the process.[9] Internal Revenue Code section 6330(e)(1) requires the collection statute of limitations to be suspended until the date the Appeals determination is final or the taxpayer withdraws the request for a hearing.[10]

The taxpayer may raise one or more of the following issues relating to the unpaid tax:

- Appropriateness of collection actions;[11]
- Collection alternatives such as installment agreement, offer in compromise, posting a bond or substitution of other assets;[12]
- Appropriate spousal defenses;[13] and,
- 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.[14]

[5] IRC § 6320(a)(2)(C) and IRC § 6330(a)(2)(C). The notice regarding a lien filing is sent after the notice of lien is filed; it is required to be sent not more than five days after the day of the filing of the notice of lien. The notice regarding a levy is sent prior to the levy action; it is required to be sent not less than 30 days before the day of the first levy.

[6] Treas. Reg. §§ 301.6320-1(c)(2), Q&A-C1 and 301.6330-1(c)(2), Q&A-C1. The Internal Revenue Service has recently approved the expanded use of faxes for receiving information and documents from taxpayers and practitioners. Form 12153, Requests for Collection Due Process Hearing, can be accepted by fax if contact has been made with the taxpayer by phone or in-person and the taxpayer history file is documented with the date of contact and notation is made that the taxpayer wishes to send the document/form/letter by fax. Internal Revenue Service Memorandum, "New Policy for Use of Fax and Signature Stamps in Taxpayer Submissions," (June 24, 2000).

[7] IRC § 6330(e)(1).

[8] IRC § 6320(b)(4).

[9] IRC § 6330(e)(1).

[10] IRC§ 6330(e)(1), and Treas. Reg. §§ 301.6320-1(g)(1) and 301.6330-1(g)(1).

[11] IRC § 6330(c)(2)(A)(ii).

[12] IRC § 6330(c)(2)(A)(iii).

[13] IRC § 6330(c)(2)(A)(i).

[14] IRC § 6330(c)(2)(B).

The 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.[15]

Collection Due Process hearings are informal and can be conducted face-to-face, by telephone or by correspondence.[16] The hearing is to be held by an impartial officer from the Appeals function of the IRS.[17] Within 30 days of the Appeals determination, the taxpayer may petition the U.S. Tax Court or where appropriate, the U.S. district court.[18] The Notice of Determination, which sets forth Appeals' findings and decisions, provides instructions for litigation, including the court of jurisdiction.[19]

The legislative history of the RRA 98 addresses in detail the standard of review that the court is to apply in reviewing the Commissioner's administrative determinations.[20] Where the validity of the tax liability was properly at issue in the CDP hearing, the amount of the tax liability will in such cases be reviewed by the appropriate court on a *de novo* basis.[21] Where only the collection determination is properly at issue, the court will review the Commissioner's administrative determination for abuse of discretion.[22]

ANALYSIS OF LITIGATED CASES

Collection Due Process was the most litigated tax issue in the federal court system between June 1, 2002 and May 31, 2003. One hundred ninety-nine CDP cases were tried with decisions published by the courts during this period. This number is a significant increase from the 96 CDP cases litigated in the previous 12 months.[23] Table 1 in Appendix 2 provides a detailed listing of litigated CDP cases, and includes specific information regarding the type of taxpayer.

The outcomes of the CDP cases were as follows:

- One hundred forty-six decisions were rendered in favor of IRS,
- Forty-five cases were dismissed,[24]

[15] IRC § 6330(c)(4).

[16] Treas. Regs. §§ 301.6320-1(d)(2), Q&A-D6 and 301.6330-1(d)(2), Q&A-D6.

[17] IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1) and 6330(b)(3).

[18] IRC § 6330(d)(1).

[19] Treas. Reg. §§ 301.6320-1(f)(2), Q&A-F3 and 301.6330-1(f)(2), Q&A-F3.

[20] H.R. Conf. Rep. No. 105-599, at 266 (1998)

[21] *De novo* - anew. *Black's Law Dictionary* 447 (7th ed. 1999).

[22] Abuse of discretion - 1. an adjudicator's failure to exercise sound, reasonable, and legal decision making. 2. An appellate court's standard for reviewing a decision that is asserted to be grossly unsound, unreasonable or illegal. *Black's Law Dictionary* 10 (7th ed. 1999).

[23] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002) p. 273.

[24] Dismissals are those decisions where the court dismissed the case or granted the motion to dismiss because (1) the taxpayer failed to state a claim upon which relief could be granted, (2) the taxpayer was late in requesting a CDP hearing or petitioning the Court, (3) the Court otherwise lacked jurisdiction, and (4) other miscellaneous reasons.

- One case was decided in favor of the taxpayer,
- Six cases resulted in split decisions,[25] and
- One case was sent back to IRS Appeals for a hearing.

The table below compares court decisions analyzed for the 2003 and 2002 Annual Reports to Congress. It reflects a notable increase in decisions in favor of the IRS and a decrease in dismissed cases:

TABLE 3.1.1 2002 & 2003 DECISIONS

2003 PERCENTAGE	COURT DECISIONS	2002 PERCENTAGE
73%	Decided for IRS	54%
23%	Dismissed	36%
1%	Decided for Taxpayer	3%
3%	Split Decision	3%
0%	Sent Back to Appeals	4%

The following are examples of cases that were litigated and the IRS prevailed:

- In *McCorkle v. Commissioner*,[26] the taxpayer, a self-employed realtor, requested an installment agreement. She proposed that after expenses were deducted from her commission checks, IRS would receive a percentage of what remained. The court upheld the IRS rejection of the installment agreement because (1) it would force a continual audit of the income and deductions the taxpayer claimed, (2) the taxpayer had not paid her current year taxes in full at the time the installment agreement was considered, and (3) the agreement would not necessarily provide for full payment of the taxes owed within the statutory period of collections.
- The Appeals officer in *Schenkel v. Commissioner*[27] rejected a proposed Offer In Compromise (OIC) because the taxpayer could fully pay the liability and the offer was therefore not within the IRS guidelines. The Appeals officer offered the taxpayer an installment agreement, to which the taxpayer did not respond. The court found that the officer's decision was reasonable, and not an abuse of discretion.

Ten of the 45 dismissed cases include a ruling by the court that the taxpayer failed to state a claim upon which relief could be granted:

- In eight of the 10 cases dismissed for failure to state a claim upon which relief could be granted, the underlying amount owed was attributable to the frivolous

[25] This analysis considered a split decision one where part of the decision favored the taxpayer and part of the decision favored IRS.

[26] McCorkle v. Comm'r, T.C. Memo. 2003-34.

[27] Schenkel v. Comm'r, T.C. Memo. 2003-37.

return penalty asserted under IRC § 6702.[28] For example, in *Gifford v. United States*,[29] the taxpayer requested that the penalty determination be declared invalid and he receive reimbursement for his costs. The court determined that there was no doubt as to the validity of the penalty because the tax returns filed were substantially incorrect and frivolous on their face. Because the penalty was valid, the court did not reach the taxpayer's request for costs.

- In *Beery v. Commissioner*[30] the taxpayer claimed that there were "no valid Tax Court decisions with respect to his liability," and because he had previously filed bankruptcy, "the Service could collect from the bankruptcy trustee." The court discussed at length previous cases involving the taxpayer and how they related to this particular case and the bankruptcy matter. The Tax Court ruled that the taxpayer had the opportunity to address the underlying liability, that he was precluded from again raising the underlying tax liability, and that the taxpayer did not offer any other remedies. Therefore, the case was dismissed for failure to state a claim.

Seven of the 45 dismissed cases involved late filing, whereby the court lacked jurisdiction:

- In *Schake v. Commissioner*[31] the Tax Court ruled that it was required to dismiss the case because the petition was mailed to the court one day after the expiration of the 30-day filing period. The taxpayer asserted that Court personnel told him that he would be given a grace period to file his petition. The Court disregarded the argument and noted that it was well settled that the Court has no authority to extend the statutory period for filing a timely petition.

The taxpayers prevailed in one case:

- In *Hoffman v. Commissioner*,[32] the taxpayers filed an amended return reporting cancellation of indebtedness income and remitted payment for the tax. The return was filed two days before the six-year anniversary of the filing of the original return. The IRS assessed the tax and issued a notice of intent to levy for penalties and interest. The taxpayers, who were partners in six partnerships, requested a CDP hearing and claimed that the statute of limitations on assessment had expired at the time the IRS assessed the liability. The IRS asserted that the six-year statute of limitations under IRC 6501(e) applied for a 25 percent omission. The IRS did

[28] Gifford v. United States, 90 A.F.T.R.2d (RIA) 7515 (D. Nev. 2002), Martinec v. United States, 90 A.F.T.R.2d (RIA) 5678 (D. Nev. 2002), Gregory v. United States, 91 A.F.T.R.2d (RIA) 871 (N.D. Ga. 2003), Bentley v. Internal Revenue Service, 2002-2 U.S.T.C. (CCH) P50,751 (N.D. Ohio), Tornichio v. United States, 263 F. Supp. 2d 1090 (N.D. Ohio 2002), Rennie v. Internal Revenue Service, 216 F. Supp. 2d 1078 (E.D. Cal. 2002), Johnson v. United States, 90 A.F.T.R.2d (RIA) 7607 (D. Nev. 2002), Stanley v. United States, 90 A.F.T.R.2d (RIA) 7536 (D. Nev. 2002).

[29] Gifford v. United States, 90 A.F.T.R.2d (RIA) 7515 (D. Nev. 2002).

[30] Beery v. Comm'r, T.C. Memo. 2003-38.

[31] Schake v. Comm'r, T.C. Memo. 2002-262.

[32] Hoffman v. Comm'r, 119 T.C. 140 (2002)

not produce any partnership returns in support of the claimed 25 percent omission from gross income, and instead argued that the partnership income was not relevant to the determination because the taxpayers did not materially participate in the partnerships. The Tax Court held that the 25 percent omission rule required the inclusion of the partnerships' gross income - regardless of material participation. As a result, the assessment against the taxpayer was untimely, and the proposed levy action improper.

Split decisions occurred in six cases:

- In *Lister v. Commissioner*,[33] the court upheld the proposed collection action. It denied the government's recommendation to impose a sanction against the taxpayer pursuant to IRC § 6673.[34]
- *Rivera v. Commissioner*[35] involved tax years 1977 through 1992, 1994, and 1997. As to the 1977 through 1983 years, the Tax Court remanded the case for further proceedings, because the taxpayer had raised an irregularity in the assessment procedure. The taxpayer could not challenge the underlying liabilities for the 1984 through 1992, 1994, and 1997 years because he had either signed a consent to assessment, or self-assessed those years.
- In *Silver v. United States*,[36] the Court granted summary judgment to the government relating to the lien imposed for unpaid income taxes for 1995 and 1996. A second lien was imposed for failure to pay a civil penalty that was assessed for filing a frivolous tax return. At the request of the government, the court remanded to the Appeals office the issue of the propriety of the second lien. The court determined that the Appeals officer erred by not allowing the taxpayer to raise the issue of the merits of the frivolous return penalty at her CDP hearing.

One case was sent back to Appeals for an additional CDP hearing:

- The Tax Court found in *Tatum v. Commissioner*[37] that the taxpayers should have been allowed to challenge their underlying tax liability in their CDP hearing. The evidence showed that the U.S. Postal Service had attempted to deliver the notice of deficiency only once before returning the envelope and its contents to the IRS as "unclaimed." The Court determined on its observation of the taxpayers during their testimony at trial that they did not deliberately refuse delivery of the notice. As a result, they had no prior opportunity to contest their liability and were entitled to dispute that liability in the context of their CDP hearing.

[33] Lister v. Comm'r, T.C. Memo. 2003-17.

[34] IRC § 6673(a)(1) authorizes the Tax Court to impose a penalty not in excess of $25,000 on any taxpayer who institutes or maintains proceedings in the Tax Court primarily for delay, asserts a position in such proceedings that is frivolous or groundless, or unreasonably fails to pursue administrative remedies.

[35] Rivera v. Comm'r, T.C. Memo. 2003-35.

[36] Silver v. United States, 90 A.F.T.R.2d (RIA) 6575 (W.D.N.Y. 2002).

[37] Tatum v. Comm'r, T.C. Memo. 2003-115.

Pro Se Analysis

Eighty-eight percent of the 199 CDP cases litigated were brought before the courts by the taxpayer, *pro se*, without benefit of counsel. This is a significant increase from the 70 percent in the previous year.[38]

The 24 cases in which taxpayers retained representation involved nine individual and 15 business taxpayers. Of the eight cases where the taxpayers either prevailed in court, received split decisions, or had their cases sent back to Appeals for a CDP hearing, two were represented by counsel.

Table 3.1.2 shows the breakdown of the *pro se* and represented taxpayers for the cases litigated, and indicates the decisions rendered by the court.

TABLE 3.1.2, PROCEDURAL ISSUES

COURT DECISIONS	TAXPAYER *PRO SE*		REPRESENTATION	
	VOLUME	PERCENTAGE OF TOTAL	VOLUME	PERCENTAGE OF TOTAL
Decided for IRS	132	76%	14	59%
Dismissed	37	21%	8	33%
Decided for Taxpayer	0	0%	1	4%
Split Decision	6	3%	0	0%
Sent Back to Appeals	0	0%	1	4%.
Totals	175	100%	24	100%

The analysis of the litigated cases identified numerous procedural issues that taxpayers raised in their CDP petitions and on which the courts ruled. Collection Due Process issues are placed and discussed in the following categories: Issues Raised at CDP Hearings, Opportunity for Hearing, Jurisdiction, Type of Hearing, No Hearing Held, Tape Recording of Hearing, and Miscellaneous Issues.

Issues Raised at CDP Hearings

In *Behling v. Commissioner*,[39] the Tax Court held that even though an Appeals officer permits the underlying tax liability to be discussed at a CDP hearing, the restriction set forth in IRC § 6330(c)(2)(B) [that the underlying tax liability cannot be raised if the taxpayer has received the notice of deficiency, or had an opportunity to challenge it, and therefore cannot seek judicial review] is not waived by that discussion.

[38] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002) p. 256.

[39] Behling v. Comm'r, 118 T.C. 572 (2002).

Carey v. Commissioner[40] is closely related to *Tatum v. Commissioner*, which was discussed earlier in this analysis. In Carey, the court found that although the notice of deficiency was returned "unclaimed," the Postal Service had attempted to deliver the notice on two occasions. The court concluded that based on the facts and circumstances of the case, coupled with their observation of the taxpayers during their testimony, the taxpayers "deliberately refused delivery of the notice." As a result, they could not raise the underlying tax liability at their CDP hearing.

Opportunity for Hearing

What does it mean to have an opportunity to dispute tax liability where there is no notice of deficiency? This question can arise for example, when the tax is assessed pursuant to a voluntarily filed tax return. In *Horn v. Commissioner*,[41] the taxpayer argued that, with regard to certain of the tax years before the Tax Court, he could raise the underlying tax at the CDP hearing because he had not had an opportunity to do so earlier. He had not received a notice of deficiency because his tax liability was based on a voluntarily filed return. As a result, the IRS argued that he could not raise the underlying liability. The Tax Court stated it did not need to address the issue because the taxpayer failed to provide any evidence of error, although given numerous opportunities to do so.

However, in a footnote the Court notes that after IRS's brief was filed, it published additions to the Appeals procedural manual that appeared to contradict IRS's litigation position in this case. The Court reprinted the procedures that are set forth in the Appeals procedural manual. The procedures detail Appeals' interpretation of what *"have an opportunity to dispute such tax liability"* means. The procedures explain that the taxpayer must be advised in writing of the opportunity to dispute their issue by going to Appeals, and further state, "[W]e do not assume that taxpayers are aware of their legal rights unless they have been advised."[42] The procedures then provide three examples of what does NOT constitute an opportunity to dispute the liability:

a. Having an opportunity to pay the tax and file a claim for refund, and not having done so, does not constitute an opportunity to dispute the liability.

b. Also, not having filed an amended return during the applicable time period does not constitute an opportunity to dispute the liability.

c. Having an opportunity to dispute the liability means an opportunity occurring before the claim period, (in most cases, this means before assessment, but in all cases it means before payment). This may be the chance to go to Tax Court, or otherwise having the chance to go to Appeals (whether deficiency or non-deficiency cases).[43]

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[40] Carey v. Comm'r, T.C. Memo. 2002-209.

[41] Horn v. Comm'r, T.C. Memo. 2002-207.

[42] Internal Revenue Manual 8.7.2.3.8(6).

Jurisdiction

In both *Washington v. Commissioner*,[44] and *Richardson v. Commissioner*,[45] the Tax Court decided on bankruptcy dischargeability issues in the context of CDP lien proceedings. In Washington, the Tax Court explains that in deficiency proceedings, it had previously held that it did not have jurisdiction because that action had nothing to do with collection of the tax debt. However, these CDP cases have everything to do with collection of unpaid taxes. The Tax Court stated it had to determine whether the IRS could proceed with collection action. Whether the bankruptcy court has discharged the specific tax years in question has a direct bearing on that decision. As a result, the court held it has jurisdiction to make the determination whether the taxes were discharged. The facts in the *Richardson* case were similar to the *Washington* case.

In both cases, the taxpayers claimed that the IRS could not proceed with collection action because the tax years on which they owed had been discharged through a bankruptcy proceeding. Through a review of the provisions of Section 523 of the Bankruptcy Code, the court determined that both taxpayers' income tax liabilities were not discharged, and the filing of a tax lien was an appropriate collection action.

In another case, the Tax Court held that its jurisdiction includes jeopardy levy determinations under IRC § 6330(f).[46]

A frequently raised jurisdictional issue is whether a frivolous return penalty case should be heard in the district courts or the Tax Court. Our analysis confirmed the continuing problem of the CDP case being brought before the incorrect court.

[43] Internal Revenue Manual 8.7.2.3.8(6).

[44] Washington v. Comm'r, 120 T.C. 114 (2003).

[45] Richardson v. Comm'r, T.C. Memo. 2003-154.

[46] Dorn v. Comm'r, 119 T.C. 356 (2002). IRC § 6330(f) provides that if the IRS finds collection of the tax is in jeopardy or if a levy is served to collect a state tax refund, the taxpayer shall be given the opportunity for a CDP hearing after the levy, not before.

Type of Hearing

In *Craig v. Commissioner*,[47] the taxpayer received an "equivalent hearing" rather than a CDP hearing. IRS later acknowledged that it should have held a CDP hearing. The Tax Court concluded that the decision letter (sent after an equivalent hearing) constituted a "determination" within the meaning of section 6330(d)(1), and held that it had jurisdiction to decide the case.

In *Frank v. Commissioner*,[48] the Tax Court found that the taxpayers were offered and participated in a telephonic hearing. At the time the telephonic hearing was offered, they did not object to that offer or request a face-to-face hearing. The taxpayer's contention that they were denied a face-to-face hearing was raised in their petition to the Tax Court and was rejected.

No Hearing Held

In *Bartschi v. Commissioner*,[49] the IRS did not hold a hearing. Instead, IRS issued the Notice of Determination based on both information available in the file, and that submitted by the taxpayer. The IRS moved for summary judgment. The taxpayers claimed that the IRS made its decision without affording them a hearing, and the IRS responded by saying the taxpayers "were given ample opportunity for a face-to-face hearing." The Court found that other than the claim that they were denied a hearing, the arguments raised by the taxpayers had been repeatedly rejected. The Court ruled that because the arguments raised by petitioners were frivolous, it was not necessary or productive to remand this case to Appeals to hold a hearing. The Court granted the IRS motion for summary judgment and held that Appeals did not abuse its discretion.

The IRS also did not hold a hearing in *Robinson v. Commissioner*.[50] The Appeals officer determined that the matters advanced did not require a hearing, but in a letter invited additional information that would indicate the taxpayer is "not liable for the unpaid liabilities at issue, requesting an installment agreement or requesting an offer in compromise." The taxpayer did not respond with additional information, received a Notice of Determination upholding the collection action, and petitioned the Court to dismiss the case on the ground that Appeals did not hold a hearing with him. The IRS acknowledged that based on its procedural manual it should have held a hearing with the taxpayer.[51]

[47] Craig v. Comm'r, 119 T.C. 252 (2002). A taxpayer whose CDP hearing request is not timely may request an equivalent hearing. This hearing mirrors the CDP hearing in most regards, with the following exceptions: Appeals issues a Decision Letter, not a Notice of Determination; periods of limitation (i.e., collection) are not suspended; collection action is not required to be suspended; court review is not available. Treas. Reg. §§ 301.6320-1(i), Q&A I 1-5, 301.6330-1(i), Q&A I 1-5.

[48] Frank v. Comm'r, T.C. Memo. 2003-88.

[49] Bartschi v. Comm'r, T.C. Memo. 2002-268.

[50] Robinson v. Comm'r, T.C. Memo. 2003-77.

[51] Internal Revenue Manual 8.7.2.3.3(5)d. This section requires the IRS to give a CDP hearing to everyone that qualifies, even when the only issues raised are frivolous.

However, the IRS contended that a hearing was not necessary or productive in this case, relying on *Lunsford v. Commissioner*, 117 T.C. 183, 189 (2001).[52] The Court agreed, finding the taxpayer's statements, contentions, arguments, and requests to be frivolous and/or groundless.

Tape Recording of Hearing

The IRS Appeals office changed its procedures in April 2002 to not allow audio, video, and stenographic recordings of its hearings. Appeals' decision relied on its interpretation that IRC § 7521 did not apply to Appeals.[53]

Although this analysis only reviewed litigated court decisions through May 31, 2003, two Tax Court cases decided on July 8, 2003 directly speak to the issue of tape recording of CDP hearings:

- In *Keene v. Commissioner*,[54], the Tax Court held that under the provisions of IRC § 7521(a)(1), the taxpayer was entitled to record his CDP hearing. The taxpayer appeared at the hearing with his recording equipment, and left prior to the hearing beginning when he was told he would not be allowed to record.
- The CDP hearing was held in *Kemper v. Commissioner*,[55] but the Appeals officer would not allow it to be recorded. The taxpayers argued that decision was improper. The Tax Court ruled the taxpayers had, from the time of filing their return through the Tax Court proceeding, made statements and requests and advanced contentions, arguments, and questions that the Court found frivolous and/or groundless. As a result, it was not necessary and it would not have been productive to remand the case to the Appeals office for another hearing.

The majority opinion in *Keene* states that its holding is not inconsistent with *Kemper*. The majority explains that in the *Kemper* case, the taxpayer chose to participate in the CDP

[52] In this reviewed case, the majority said the taxpayers claimed that the Appeals officer had incorrectly relied on Form 4340, "Certificate of Assessments and Payments", in verifying the tax assessment, and the officer had not allowed the taxpayers to challenge the Form 4340. The majority explained they had already decided this issue in another case against the taxpayer's position. Because they had already ruled on this issue, sending the case back to Appeals for a hearing was neither necessary nor productive. One of the dissenting opinions felt there was a clear abuse of discretion, evidenced by the Appeals officer not holding a properly requested CDP hearing. The other dissenting opinion concluded that the majority ruling had, in an effort to expedite the collection process, rewritten provisions of the CDP law, and had no authority to do so.

[53] Internal Revenue Manual 8.7.2.3.4, states, "(2) IRC Section 7521 authorizes both taxpayers and the IRS to audio record in-person interviews dealing with the determination or collection of taxes. These in-person interviews are initiated by the IRS for the purpose of gathering information regarding a taxpayer's tax liability, income or assets. Unlike interviews with Collection and examination, conferences with Appeals are new hearings requested by the taxpayer, at which the taxpayer raises issues for consideration. On that basis, it has been determined that IRC 7521 does not apply to Appeals."

[54] Keene v. Comm'r, 121 T.C. 8 (2003). This was a Court reviewed decision with 13 judges agreeing with the majority opinion, and three dissenting.

[55] Kemper v. Comm'r, T.C. Memo. 2003-195.

hearing, and subsequently included frivolous and groundless arguments along with the tape recording argument. In the *Keene* case, however, no hearing was held and the taxpayer raised only the tape recording issue in his petition to the court.

The Office of Chief Counsel of IRS has recently provided guidance about recording face-to-face CDP hearings. If requested, an audio recording of the face-to-face conference will be permitted in accordance with IRC § 7521.[56]

Miscellaneous Issues

During the period under review, the courts addressed a wide variety of issues. Some additional examples are explained below:

- In *Bullock v. Commissioner*,[57] the Tax Court ruled that applying a taxpayer's overpayment from one taxable year against the taxpayer's liability for another taxable year is not a collection action subject to review under IRC §§ 6320 or 6330.
- In *Muldavin v. Commisioner*, the court found that "Notice of Federal Tax Lien Filing and Your Right to a Hearing Under I.R.C. 6320" is valid even if it is given before the lien is filed.[58]
- The *Voorhees v. Commissioner*[59] case reinforces the importance of married taxpayers signing the CDP hearing request. Even though Mrs. Voorhees had signed the petition to the Tax Court, it dismissed her portion of the case because she had not signed the initial CDP hearing request and as a result had not received a Notice of Determination.
- In *Schrems v. Commissioner*,[60] the taxpayer declined to participate in the CDP hearing because he was not allowed to conduct discovery or to compel the appearance of witnesses.
- In *Eiselstein v. Commissioner*,[61] the taxpayer appears to argue that she was not provided documents demonstrating that the verification requirements of IRC § 6330 had been met. The Court responded that the Commissioner is not required to provide a taxpayer with a copy of the verification, nor is he required to rely on a particular document to satisfy the verification requirement. The transcripts of an account meet the requirement of verification.

56 Internal Revenue Service, Office of Chief Counsel Notice CC-2003-031 (Sept. 11, 2003), Face-To-Face Conferences with Appeals in Collection Due Process Cases.

57 Bullock v. Comm'r, T.C. Memo. 2003-5.

58 Muldavin v. Comm'r, T.C. Memo. 2002-182.

59 Voorhees v. Comm'r, T.C. Memo. 2002-289.

60 Schrems v. Comm'r, T.C. Memo. 2003-25.

61 Eiselstein v. Comm'r, T.C. Memo. 2003-22. IRC § 6330(c)(1) provides that the Appeals officer obtain verification from the IRS that the requirements of any applicable law or administrative procedure have been met.

CONCLUSION

The opportunity to have an independent Appeals officer review CDP cases provides a much-needed safety valve in the collection process, as does the courts' review of tax determinations and assessments. The important protections that CDP affords may be undermined by certain trends in CDP filings as well as the IRS's response to those trends.

Continuing Problem with Frivolous Filers

The analysis conducted for this report reveals a continuing problem with taxpayers who submit frivolous arguments within the CDP procedure. This analysis identified 52 percent of the cases as frivolous. The criteria used to identify a case as frivolous were: (1) an IRC § 6702 penalty (commonly referred to as frivolous return penalty) upheld by the court, (2) an IRC § 6673 sanction imposed by the Tax Court (or Appeals Court), or (3) the court labeling as frivolous the arguments presented by the taxpayer.

While the IRS has a legitimate need to reduce the number of frivolous submissions and cases, its challenge will be to provide for taxpayer rights while completing this task. This will require a careful review of the information submitted by each taxpayer, even those eventually deemed frivolous. The *Lister* case demonstrates the importance of this careful review. Here, the Tax Court denied the government's recommendation to impose an IRC § 6673 penalty:

> While we acknowledge respondent's [IRS's] concerns regarding petitioner's [the taxpayer's] arguments in this case, we are unable to conclude on this record that petitioner instituted or maintained these proceedings primarily for delay or that petitioner unreasonably failed to pursue available administrative remedies. The letters reflected a profound confusion on the part of petitioner regarding her entitlement to refunds and credits arising from such things as the personal exemption and the credit for the disabled and elderly. We are not prepared on this record to equate petitioner's apparent confusion with a deliberate attempt on her part to delay or obfuscate.
>
> We also note that the record fails to establish that all of petitioner's claims were frivolous or groundless. While petitioner's filings were confused, often unintelligible, and sometimes reminiscent of protester rhetoric, not all of the arguments contained in those filings were frivolous or groundless on their face. Consequently, we shall deny that part of respondent's motion that seeks a penalty under section 6673. We warn petitioner, however, that most of her arguments in this case were, to the extent that we understood them, of the type that might justify the imposition of a section 6673 penalty if petitioner were to assert those arguments again in another judicial proceeding in this Court.[62]

[62] Lister v. Comm'r, T.C. Memo. 2003-17.

New Penalty Provisions Regarding Frivolous Submissions

A bill currently before Congress contains provisions that would increase the frivolous return penalty from $500 to $5000, and apply it to all taxpayers and to all types of federal taxes. The bill would also modify present law with respect to certain submissions (including CDP hearing requests) that raise frivolous arguments or that are intended to delay or impede tax administration. This provision would impose a penalty of $5,000 unless the taxpayer withdraws the submission within 30 days after being notified that the submission is frivolous. Finally, the IRS would be required to publish a list of positions, arguments, requests and proposals determined to be frivolous.[63]

The following questions regarding the proposed changes to frivolous submissions were raised in last year's Annual Report to Congress, and bear repeating:

- Who will be empowered to determine whether submissions are frivolous? What procedures will IRS have in place to make these determinations? Where will this process be located in the IRS organization?
- Will there be an independent review of these determinations? What appeal rights will taxpayers have concerning the proposed assertion of these penalties?
- Will submissions that raise both significant procedural issues as well as frivolous grounds survive this process?
- Will the IRS be diligent in correcting a "frivolous" designation erroneously placed on the database?[64]

Consolidating CDP Cases into Tax Court

The litigated case analysis found confusion regarding the issue of which court (Tax Court or district courts) should hear frivolous return penalty cases. In *Gillett v. United States*,[65] the district court ruled in favor of the United States, granting summary judgment and affirming an administrative decision imposing the sanction. In its discussion, however, the Court said:

> Many federal courts have held that because it is related to income taxes, judicial review under § 6330(d) of frivolous tax return penalties falls within the exclusive jurisdiction of the Tax Court and outside the jurisdiction of the United States District Courts. . . The Tax Court has held that it does not have jurisdiction to consider frivolous return penalties. . . The federal appellate courts have not yet resolved whether review lies within the district courts or the Tax Court.[66]

[63] Taxpayer Protection and IRS Accountability Act of 2003, H.R. 1528, 108th Cong. § 107 (2003).

[64] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002) p. 277.

[65] Gillett v. United States, 233 F. Supp. 2d 874, 881-882 (W.D. Mich. 2002).

Consolidating the judicial appeals of all CDP cases into the Tax Court is one resolution of this issue. Such a provision is currently before Congress.[67]

Tape Recording of Hearing

The National Taxpayer Advocate welcomes the counsel guidance providing for the tape recording of CDP hearings. In the cases reviewed for this analysis, most of the CDP hearings took place before Appeals stopped allowing audio recordings; as a result, transcripts of the hearings were used in some of the court proceedings. The analysis indicates there were instances where IRS's position actually benefited from the presence of recordings.

Type of Hearing

Recent guidance provided by the Office of Chief Counsel of IRS addresses when Appeals will offer a taxpayer a face-to-face CDP hearing:

> In cases where the CDP hearing request raises only frivolous and groundless arguments, Appeals will contact the taxpayer to ask the taxpayer to state what relevant issues the taxpayer would like to address at the hearing. If the taxpayer fails to respond or responds with only additional frivolous and groundless arguments, the taxpayer will not be offered a face-to-face conference. The taxpayer will instead be provided a CDP hearing through telephone conferences, written correspondence, or some combination thereof. If the taxpayer responds with specificity that the issues to be discussed are valid collection alternatives or other nonfrivolous issues pertaining to the lien or levy, then a face-to-face conference will be offered to the taxpayer.[68]

Although it is important that efforts are taken to reduce frivolous arguments, these directions raise some concerns about protecting taxpayer rights and may likely result in more, not less litigation. In light of the large number of *pro se* taxpayers in CDP hearings, Appeals must be very careful not to equate confused or poorly developed issues with frivolous or groundless arguments, as it did in *Lister v. Commissioner*. The Collection Due

[66] Gillett v. United States, 233 F. Supp. 2d 874, 881-882 (W.D. Mich. 2002). In Van Es v. Comm'r, 115 T.C. 324 (2000), the Tax Court held that it does not have jurisdiction to consider frivolous return penalties asserted under IRC § 6702. The Tax Court explained because it does not have jurisdiction over the assessment of these frivolous return penalties, it similarly lacks jurisdiction over the collection of those same penalties.

[67] Taxpayer Protection and IRS Accountability Act of 2003, H.R. 1528, 108th Cong. § 303 (2003).

[68] Internal Revenue Service, Office of Chief Counsel Notice CC-2003-031 (Sept. 11, 2003), Face-To-Face Conferences with Appeals in Collection Due Process Cases.

Process hearing is a significant taxpayer protection and increases in importance as the IRS ramps up its collection activity. The National Taxpayer Advocate will diligently monitor legislative and administrative changes to CDP to ensure those protections and safeguards are not eroded.

LITIGATED
ISSUE #2 MOST LITIGATED ISSUE: INCOME ISSUES

SUMMARY

Income reporting remains an issue of confusion for taxpayers. The income issues are similar to those detailed in the National Taxpayer Advocate's *Annual Report to Congress* for 2002.[1] The analysis of litigated income cases conducted for this report reveals similar patterns of frivolous arguments, unreported income cases, and income received as part of a nonphysical personal injury settlement or award. The 2002 Annual Report to Congress identified an inequity in how the deduction claimed for attorney fees was treated when income was received as part of a nonphysical personal injury settlement or award.[2] The treatment of the deduction for attorney fees varied based on the jurisdiction in which the taxpayer resided. The National Taxpayer Advocate proposed a legislative recommendation to eliminate the inconsistency between jurisdictions.[3]

The distinction between exempt and non-exempt income items for tax purposes, along with other complexities in the tax law, has contributed to improper reporting of income, especially the difficulty in distinguishing between retirement and disability income. Although these two types of income can be similar, each is treated differently for tax purposes.

The analysis of the litigated partnership income cases identified an aspect of the notice procedures for TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) cases[4], involving partnership returns covering more than 100 partners, which gives rise to litigation. A limited partner with less than a one percent voting and ownership interest in the partnership will not receive notice of an audit or the audit results unless he or she is part of a five percent group of partners and requests such notices.[5] All partners are bound by decisions made at the partnership level by the tax matters partner (TMP), and judicial review is limited, whether or not the other partners received notice.[6] The regulations allow for a non-notice partner to file an election not to be bound by any TMP settlement.[7] However, the taxpayer must be aware of the regulation and file the election. The IRS could include information about the election in the partnership instruction publications or a legislative change could provide such notices be sent to all partners, regardless of partnership interest. However, additional costs would be associated with an expanded

[1] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 258 - 271.

[2] Id. p. 262.

[3] Id. p. 160.

[4] Pub. L. No 97-248, § 402(a).

[5] IRC § 6223 (b) (2).

[6] IRC §§ 6227 and 6228.

[7] Treas. Reg. §§ 301.6224(c) - 1(a)(2) & (c).

notice requirement, including increased administrative burden. The notice requirement would not affect the results of the audit because the partnership agreement would continue to be binding on the partners.

PRESENT LAW

The passage of the 16th Amendment to the U.S. Constitution in 1913 authorized federal taxation of income but did not define how income should be measured. Some income is exempt from tax, some is taxed once, and other income, such as dividend income and some foreign income, is taxed multiple times.[8] Income may be taxed when earned, realized, or received.[9]

Current law defines gross income as "all income from whatever source derived."[10] Gross income includes (but is not limited to) the following:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

[8] Dividend income is taxed as corporate profits when earned by the corporation and again when distributed to the shareholder, IRC §§ 1, 3, 11, 61(a)(7) and 63.

[9] Some sections of the IRC which describe potentially reportable income include IRC §§ 72(a) and (b), 83, 631, 911(d)(2), 1031, and 1221.

[10] IRC § 61(a).

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust. [11]

Although the rules may seem to be self-explanatory, there are many inclusions and exclusions in the law, which further complicate the concept of income. Internal Revenue Code sections 71 through 90 address items that are specifically included in gross income, while IRC §§ 101-140 address items specifically excluded. The tax code also contains special rules governing the treatment of retirement income.[12] These rules address Individual Retirement Accounts (IRA) as well as more complicated investments through company financed retirement and benefits packages.[13] There are specialized rules for the inclusion of employee benefits in income; IRC §§ 421-424 govern the treatment of stock options as compensation, IRC § 125 covers cafeteria plans, and IRC §§ 62, 219, 401, 402, and 415 cover qualified retirement plans.

The many types of compensation exacerbate the problem of defining compensation for services. Compensation for services covers many benefits an employer might provide an employee, including wages,[14] tips,[15] compensation to an employee or the employee's heirs for disability or death,[16] awards,[17] dependent care assistance,[18] meals and lodging provided by the employer,[19] employee stock options, [20] stock purchase plans,[21] tuition benefits,[22] employer provided moving expenses,[23] life insurance benefits,[24] health insurance benefits,[25] legal services,[26] property in exchange for services,[27] imputed interest,[28] and more. There are

[11] IRC §§ 61(a)(1), (2), (3), (4), (5), (6), (7), (8), (9), (10), (11), (12), (13), (14), & (15).

[12] IRC §§ 62, 72, 122, 132, 217(i), 219, 401-424.

[13] IRC §§ 72, 219, 401-409.

[14] IRC §§ 3121(a), 3306(2)(b), 3401(a).

[15] IRC § 6053.

[16] IRC § 3121(a)(2), (4) and (13).

[17] IRC § IRC 74(a).

[18] IRC § 129(d).

[19] IRC § 119.

[20] IRC § 422.

[21] IRC §§ 423, 1042.

[22] IRC §§ 117, 3121(a)(20).

[23] IRC §§ 217, 3121(a)(11).

[24] IRC §§ 79, 264, 3102(d), 3202(d).

[25] IRC §§ 105, 4980D, 9811, 9812, 9831, 9832.

[26] IRC § 120(a)(2).

[27] IRC §§ 83, 311, 707(b)(2).

[28] IRC § 7872.

also special rules governing the compensation of highly compensated employees and key employees.[29]

ANALYSIS OF LITIGATED CASES

One hundred seventy-five cases involving the issue of income were decided in the federal court system between June 1, 2002 and May 31, 2003. The following detailed analysis of cases is limited to certain categories with a high volume of cases, and to a follow-up of issues identified in the 2002 Annual Report.[35] Table 2 in Appendix 2 provides a detailed listing of the cases. The following table categorizes the types of income issues that were litigated.

[29] IRC §§ 79(d)(6), 105(h), 117(d)(3), 125(b), 401(a)(5) & (k)(5), 410(b), 414(q), 416 (i) (1), 419A(d).

[30] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 260 - 271.

TABLE 3.2.1, INCOME ISSUES IDENTIFIED FROM ANALYZED CASES

INCOME CATEGORY	NUMBER OF CASES	PERCENTAGE OF TOTAL CASE POPULATION
Frivolous Arguments/Frivolous Claims	39	22%
Unreported/Underreported Income	22	13%
Compensation for Services	18	10%
Dividend Income	14	8%
Pension or Retirement Income	13	7%
Rental Income	12	7%
Partnership Income	11	6%
Interest Income	7	4%
Settlement Income	7	4%
Trust Income	6	3%
Capital Gain	4	2%
Discharge of Debt	4	2%
Gambling Income	4	2%
Commission Income	3	2%
Disability Income	3	2%
S-Corporation Income	3	2%
Estate and Gift Income	3	2%
Alimony Income	2	1%
Total	175	99%[31]

Frivolous Claims or Arguments

There were 39 litigated cases involving frivolous claims or tax arguments,[32] with most of them containing two or more arguments and the courts ruling for the government in all 39 cases. Frivolous claims or tax arguments are positions taken by taxpayers, disputing the legality of income tax or the collection of income taxes.[33] They include (but are not limited to) the following:

- Wages and/or Receipts are not Income - This argument asserts that wages, tips, and other compensation received for personal services are not income, because there is allegedly no taxable gain when a person exchanges labor for money. Under this

[31] The 99 percent is due to rounding.

[32] IRS Publication 3995, *Recognizing Illegal Tax Avoidance Schemes*, Publication 2193, *Should your Financial Portfolio include Too Good to Be True Trusts,* and Notice 97-24 (Certain Trust Arrangements, 1997-1 C.B. 409; 1997 IRB LEXIS 131; 1997-16 I.R.B. 6; Notice 97-24, April 21, 1997).

[33] IRS, "The Truth About Frivolous Tax Arguments," at http://www.irs.gov/pub/irs-utl/friv_tax.pdf.

theory, wages are not taxable income because people have basis in their labor equal to the fair market value of the wages they receive; thus, there is no gain to be taxed.[34]

- Zero Returns - The taxpayer submits a return with zero dollar amounts entered on the lines for income and taxes. A document attached to the return states that no section of the Internal Revenue Code establishes an income tax liability, and contains arguments regarding the definition of income.[35]
- Fifth Amendment - The taxpayer asserts that requiring taxpayers to file returns and provide tax information is a violation of the 5th Amendment protection against self-incrimination.[36]
- Sixteenth Amendment - Some take a different approach to the theory that wages are not income and argue that the 16th Amendment did not authorize a tax on wages and salaries, but only on gain or profit.[37]
- Taxes are Voluntary and the Law Does Not Require Tax Payment -This tax argument asserts that taxpayers are not required to pay taxes because the United States tax system is voluntary. The legal reference cited for this argument is the Supreme Court's opinion in Flora v. United States.[38]
- Challenges to Authority /Due Process - Here, the taxpayer questions various administrative authorities such as delegation orders, summons authority, Privacy Act, etc under the theory that the collection of tax is a violation of the due process

[34] IRS, "The Truth About Frivolous Tax Arguments," at http://www.irs.gov/pub/irs-utl/friv_tax.pdf; In U.S. v. Connor, 898 F.2d 942, 943-44 (3d Cir.), cert. denied, 497 U.S. 1029 (1990) - the court stated that "[e]very court which has ever considered the issue has unequivocally rejected the argument that wages are not income."

[35] IRS, "The Truth About Frivolous Tax Arguments," at http://www.irs.gov/pub/irs-utl/friv_tax.pdf; For federal income tax purposes, "gross income" means all income from whatever source derived and includes compensation for services, IRC § 61, unless the taxpayer can establish that it is specifically exempted or excluded. In Reese v. United States., 24 F.3d 228, 231 (Fed. Cir. 1994), the court stated, "an abiding principle of federal tax law is that, absent an enumerated exception, gross income means all income from whatever source derived."

[36] IRS, "The Truth About Frivolous Tax Arguments," at http://www.irs.gov/pub/irs-utl/friv_tax.pdf. In U.S. v. Sullivan, 274 U.S. 259, 264 (1927), the U.S. Supreme Court stated that the taxpayer "could not draw a conjurer's circle around the whole matter by his own declaration that to write any word upon the government blank would bring him into danger of the law."

[37] IRS, "The Truth About Frivolous Tax Arguments," at http://www.irs.gov/pub/irs-utl/friv_tax.pdf.; The Sixteenth Amendment provides that Congress shall have the power to lay and collect taxes on income, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration. U.S. Const. amend. XVI. Furthermore, the U.S. Supreme Court upheld the constitutionality of the income tax laws enacted subsequent to ratification of the Sixteenth Amendment in Brushaber v. Union Pacific R.R., 240 U.S. 1 (1916).

[38] Flora v. United States, 362 U.S. 145, 176 (1960); IRS, "The Truth About Frivolous Tax Arguments," at http://www.irs.gov/pub/irs-utl/friv_tax.pdf; The requirement to file an income tax return is not voluntary and is clearly set forth in IRC §§ 6011(a), 6012(a), and 6072(a). See also Treas. Reg. § 1.6011-1(a).

clause of the Fifth Amendment. The taxpayer may argue that he or she must be afforded a hearing or trial before the IRS can assess taxes or seize property.[39]

Nine of the 39 cases involved the "wages/receipts are not income" argument. In *Tough v. Internal Revenue Service*,[40] the taxpayer argued that there is a distinction between earnings from employment, which the taxpayer characterized as compensation, and income, which the taxpayer described as " the gain derived from a contribution of capital, from labor, or from both combined".[41] The court recognized no distinction between compensation from labor and income for taxation purposes, found the taxpayer had no claim, and dismissed the case.[42]

The "zero return" argument was presented in 14 cases. In *Jones v. Commissioner*,[43] the taxpayer submitted a return with zeros entered in the income and tax lines. The taxpayer argued that the IRS could not legally create an income tax return for him, that the letter sent by the IRS was not a legal notice, that the IRS agent was not a legal representative to send out the notice, and that he did not have income from a taxable source.[44] The court found in favor of the IRS because the taxpayers arguments were frivolous and groundless without any legal basis.[45]

Thirteen cases involved "challenges to authority and the due process procedures." *Lyman v. Commissioner*[46] is an example of this argument in the context of a judicial review of a Collection Due Process determination. In this case the taxpayers filed a return with zeros recorded in the income and tax lines.[47] The return included a statement of tax arguments that the court found groundless and frivolous. The taxpayers did not petition the courts during the examination process. Instead, they requested and received an IRS Appeals hearing under IRC § 6320 related to a notice of tax lien and under IRC § 6330 related to a notice of intent to levy. At the hearing, the taxpayers challenged the authority of the IRS and its employees and presented other income arguments that were

[39] IRS, "The Truth About Frivolous Tax Arguments," at http://www.irs.gov/pub/irs-utl/friv_tax.pdf; The Fifth Amendment to the United States Constitution provides that a person shall not be "deprived of life, liberty, or property, without due process of law. ." The U.S. Supreme Court stated in Brushaber v. Union Pacific R.R., 240 U.S. 1, 24 (1916), that "it is...well settled that [the Fifth Amendment] is not a limitation upon the taxing power conferred upon Congress by the Constitution." Further, the Supreme Court has upheld the constitutionality of the summary administrative procedures contained in the IRC against due process challenges, on the basis that a post-collection remedy (e.g., a tax refund suit) exists and is sufficient to satisfy the requirements of constitutional due process. Phillips v. Comm'r, 283 U.S. 589, 595-97 (1931).

[40] Tough v. IRS, 91 A.F.T.R 2d (RIA) 501 (E.D. Mich. 2002), aff'd, 92 A.F.T.R.2d (RIA) 6200 (6th Cir. 2003).

[41] Id.

[42] Id.

[43] Jones v. Comm'r, T.C. Memo. 2003-131.

[44] Id.

[45] Id.

[46] Lyman v. Comm'r, T.C. Memo. 2003-72.

[47] Id.

determined to be frivolous and without legal basis. The Appeals officer found the assessments were valid, that proper procedures were followed in making the assessments and that the IRS notices received by the taxpayer were appropriate. The Court found the taxpayer was using the collection due process procedures as a means to delay action, that the income arguments were frivolous and groundless, and imposed an additional penalty of $3,000 under IRC § 6673.[48]

In *Cabirac v. Commissioner*,[49] the taxpayer filed returns showing zero income and taxes and attached a document to the returns that attempted to invoke the Fifth Amendment right against self-incrimination as a basis for his not providing financial information on the return. The taxpayer argued before the Court that no section of the Internal Revenue Code establishes an income tax liability or provides that income taxes have to be paid. The taxpayer also argued that he had no income, since he had no earnings taxable as income under the Corporation Excise Tax Act of 1909. The Court found that wages, interest, pension, and IRA distributions were taxable under IRC § 61 and that the taxpayer's position with respect to his fifth Amendment rights was frivolous, and fined him $2,000.[50]

In twenty-three of the 39 litigated cases involving frivolous arguments the court imposed a penalty under IRC § 6673(a) (1).[51] Under IRC § 6673(a)(1) the courts can impose a penalty up to a maximum of $25,000 against a taxpayer advancing frivolous arguments.

The courts did show leniency in three of the 39 cases, opting to give the taxpayer a warning instead of imposing a penalty.[52]

Compensation for Services

Ten percent (18) of the cases decided during this period involved compensation for services. Generally, compensation for personal services rendered by a taxpayer must be included in gross income.[53] Compensation for services includes wages, salaries, commissions, and fees. A taxpayer need not receive the compensation in cash for it to be taxable.[54] The fair market value of payments received in the form of goods or services

[48] Lyman v. Comm'r, T.C. Memo 2003-72.

[49] Cabirac v. Comm'r, 120 T.C. 163 (2003).

[50] Id.

[51] Whenever it appears to the court that the taxpayer instituted the proceeding to delay the collection of tax, the proceeding is frivolous, or the taxpayer willingly failed to pursue administrative remedies, the court may impose a penalty up to a maximum of $25,000 under IRC § 6673.

[52] Hammornick v. Comm'r, T.C. Memo. 2002-219; Schaper v. Comm'r, T.C. Memo. 2002-203; Schnitzler v. Comm'r, T.C. Memo. 2002-159.

[53] IRC § 61(a) (1).

[54] IRC §§ 83, 311, 707(b)(2).

generally must be included in gross income. The other forms of compensation such as fringe benefits and stock options are also included in gross income.[55]

a. Disability Income

Three of the 18 litigated cases involved taxpayer challenge to assessments based on the taxability of disability income. One such case is *Miley v. Commissioner*.[56] Where the taxpayer claimed that his disability payments were not taxable income because premium payments made by his employer were included in his gross income. The taxpayer argued that his disability payments were therefore excludable under IRC § 104(a)(3). The taxpayer testified that $3.00 per pay period was deducted from his pay. However, the Court concluded that the taxpayer failed to establish that the disability payments he received were based "solely" on his contributions to the policy and not from contributions made by his employer. Therefore, the Court held that the disability payments received could not be excluded from income under IRC § 104(a)(3).[57]

In *Byrne v. Commissioner*,[58] which also involved the taxability of disability income, the court held for the taxpayer. The taxpayer, who was a retired judge, received disability retirement benefits under the California Judges' Retirement Law[59] for a disability sustained during the course of his employment. The IRS claimed the benefits were in the nature of workmen's compensation and therefore taxable. The court held the taxpayer received his benefits because he was unable to discharge the duties of his office due to a mental disability. Therefore, the benefits were not workmen's compensation and were excludable from gross income.[60]

In *Forste v. Commissioner*,[61] the last case involving disability income, the Tax Court ruled partially in favor of the taxpayer and partially for the IRS. The case centered on whether income received as part of a settlement agreement was related to personal injuries or sickness and therefore excludable from income. The court found that part of the settlement amount was excludable from the taxpayers' gross income as a tort or tort-like claim for personal injury under IRC § 104(a)(2).[62] The court further found the taxpayer had a serious medical condition that was sufficiently substantiated, and payments related to this issue were excludable from gross income under IRC § 104(a)(2).[63]

[55] IRC §§ 74 125, 219, 274, 421-424, and others.

[56] Miley v. Comm'r, T.C. Memo. 2002-236.

[57] Id. at 6.

[58] Byrne v. Comm'r, T.C. Memo. 2002-319.

[59] Cal. Govt. Code §§ 75000-75111 (West 1993 & Supp. 2002).

[60] Byrne v. Comm'r, T.C. Memo. 2002-319 24.

[61] Forste v. Comm'r, T.C. Memo. 2003-103 49.

[62] Id. at 53.

[63] Id.

b. Corporate Shareholders

There were four compensation cases involving the classification of income as distributions, loans to shareholders, or dividends.[64] The IRS raised the issue of whether the amounts were compensation for services or wages. In all four cases, the corporations were owned by one shareholder or owner, (i.e. closely held),[65] and the issue related to the payment of employment tax and/or income tax based on the classification of the type of distribution. The courts ruled in favor of the IRS in all four cases and re-classified the distribution of funds as compensation for services or dividends taxable to the shareholder.[66]

The remaining litigated cases involving compensation for services covered a variety of issues, including unused vacation and sick leave, military benefits, foreign income, and the characterization of receipts as wages rather than gifts.

Unreported and Underreported Income

Twelve of the 22 unreported and underreported income litigated cases involved the IRS' use of bank receipts and deposits to reconstruct income.[67] The Court ruled in favor of the IRS in all of these cases because the taxpayers had not provided sufficient substantiation for excluding receipts and deposits from income.

In *Mantakounis v. Commissioner*,[68] the IRS determined the taxpayer had income that was not included in the taxpayer's gross income, based on a Form 4789, Currency Transaction Report (CTR), filed by the taxpayer's bank. The taxpayer initially stated he found the money but later said the funds were a loan from his father. The taxpayer argued the burden shifted to the IRS under IRC § 7491 because the taxpayer had introduced credible evidence that the cash transaction was a loan.[69] The court found that IRC § 7491 applies

[64] Specialty Transp. & Delivery Serv. v. Comm'r, T.C. Memo. 2003-51; Veterinary Surgical Consultants v. Comm'r, T.C. Memo 2003-48; Water-Pure Sys. v. Comm'r, T.C. Memo. 2003-53; TCS Auto Wholesale v. United States, 90 A.F.T.R. 2d 5279 (2002).

[65] IRC § 447(h) defines a "closely held" corporation as having members of two families who own at least 65 percent of the total voting power of stock and at least 65 percent of the total number of shares.

[66] TCS Auto Wholesale v. United States, 90 A.F.T.R. 2d (RIA) 5279 (2002); Water-Pure Sys. V. Comm'r, T.C. Memo. 2003-53; Specialty Transp. & Delivery Serv. v. Comm'r, T.C. Memo. 2003-51; Veterinary Surgical Consultants v. Comm'r, T.C. Memo. 2003-48.

[67] IRC § 446(b) generally provides that when no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as does clearly reflect income.

[68] Mantakounis v. Comm'r, T.C. Memo. 2002-306.

[69] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 3001(c), 112 Stat. 685 726-727 (1998). Under the provisions of IRC § 7491(a)(1), if in any court proceeding, a taxpayer introduces credible evidence with respect to his tax liability, the burden may shift to the Commissioner. The taxpayer must satisfy these three requirements: (1) comply with all substantiation and record keeping requirements in accordance with the applicable Internal Revenue Code section; (2) cooperate with requests for witnesses, documents, meetings and interviews; and (3) if the taxpayer is a partnership, corporation or trust, that taxpayer must meet the net worth requirements (less than $7 million) of IRC § 7430(c)(4)(A)(ii).

only to court proceedings arising in connection with examinations commencing after July 22, 1998, and did not apply to this case.[70] The Court further found that the taxpayer's testimony regarding the alleged promissory note lacked credibility and upheld the IRS' determination that the amount in question was unreported income.[71]

In *Maxie v. Commissioner*,[72] the taxpayer explained that a discrepancy between the gross receipts reported and his bank deposits for the year in question was a result of him transferring funds from savings accounts and depositing funds received from loans he had previously made. The Court found the taxpayer presented no evidence to corroborate his testimony. The Court ruled the testimony was too vague and based too much upon conjecture to establish that the bank deposits related to transfers and loans.[73]

The remaining litigated unreported and underreported income cases involved various issues such as re-inclusion of dividend income, unreported wages and business income.

Partnership Income

There were 11 partnership income cases, two of which involved disputes as to whether the individual was a partner and therefore received partnership income.[74] *In Blonien v. Commissioner*,[75] the taxpayer argued that he was not a partner in the partnership and therefore cancellation of indebtedness income attributable to the partnership could not be allocated to him. The Court determined it had no jurisdiction to determine who was a partner because that issue impacted the other partners in the partnership, and as a result had to be determined at the partnership level.[76] Further, the Court held that the taxpayer did not have standing to object to the partnership level determination that he was a partner. There were two separate rationales supporting the Court's position. First, the taxpayer had claimed on prior returns that he was a partner and he had a duty of consistency. Second, the taxpayer had received a Schedule K-1 from the partnership but failed to file the form with his return that would notify the IRS that he took the position that he was not a partner in the partnership. Because the Court did not have jurisdiction over the issue of whether the taxpayer was a partner, the distributive share of cancellation of indebtedness income that was allocated to the taxpayer was properly included in his income by the IRS.[77]

[70] Mantakounis v. Comm'r, T.C. Memo. 2002-306.

[71] Id.

[72] Maxie v. Comm'r, T.C. Summ. Op. 2002-113.

[73] Id.

[74] Blonien v. Comm'r, 118 T.C. 541 (2002) and Estate of Ballantyne v. Comm'r, T.C. Memo. 2002-160.

[75] Blonien v. Comm'r, 118 T.C. 541 (2002).

[76] Blonien v. Comm'r, 118 T.C. 541 (2002), 4; IRC § 6231(a); Treas. Reg. §301.6231(a) (3)-1(a).

[77] Blonien v. Comm'r, 118 T.C. 541 (2002), 1; There is some potential conflict on the issue of whether the determination of who is a partner is a partnership item. In Grigoraci v. Comm'r, T.C. Memo. 2002-202, the Court held that the partner identity was not a partnership item. In Katz v. Comm'r, 335 F.3d 1121 (10th Cir. 2003), the court held the partner identity is a partnership item.

In *Ballantyne v. Commissioner*,[78] the Court addressed the issue of whether income earned in a farming activity was earned by the partnership in which the decedent had been a partner. The Court determined that the income was earned by the partnership and therefore, the partner's estate was required to recognize a distributive share of that income.[79] In both of these cases, the Court ruled in favor of the IRS and required the taxpayer to include the amount in income.[80]

Six partnership income cases dealt with the jurisdiction of the Tax Court and the opportunity to disagree with IRS determinations at the partner level. *Browning-Ferris Indus. v. United States*,[81] *Madison Recycling Assocs. v. Commissioner*,[82] *Field v. United States*,[83] *Gingerich v. United States*,[84] *Monahan v. Commissioner*,[85] and *Lindsey v. Commissioner*[86] raised the statute of limitations period for assessment and the jurisdiction of the court to consider partnership items of income versus partner's items of income.[87] The IRS prevailed in all cases that went to trial. *Browning-Ferris Indus v. United States*[88] was before the court on a motion of summary judgment, to determine if the court had jurisdiction over the partnership income adjustments. The court determined that it had jurisdiction and the case will now go to trial.[89]

Provisions of the 1982 Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) govern IRS procedures for partnership examinations and the court's jurisdiction of partnership items.[90] TEFRA provides for specific notice requirements, and makes partnership income adjustments binding on the partner at the partnership level.[91] The regulations allow for a non-notice partner to file an election not to be bound by any TMP settlement.[92] However, the taxpayer must be aware of the regulation and file the election.

[78] Estate of Ballantyne v. Comm'r, T.C. Memo. 2002-160.

[79] Id. at 25

[80] Blonien v. Comm'r, 118 T.C. 541 (2002) and Estate of Ballantyne v. Comm'r, T.C. Memo. 2002-160.

[81] Browning-Ferris Indus. v. U.S., 233 F. Supp. 1223 (D. Ariz. 2002).

[82] Madison Recycling Assocs. v. Comm'r, 295 F.3d 280 (2d Cir. 2002).

[83] Field v. U.S., 89 A.F.T.R.2d. (RIA) 2993 (S.D.N.Y. 2002), vacated & remanded, 328 F.3d. 58 (2d Cir. 2003), on remand, 92 A.F.T.R.2d. (RIA) 6929) (S.D.N.Y. 2003).

[84] Gingerich v. U.S., 54 Fed. Cl. 222 (2002).

[85] Monahan v. Comm'r, 321 F3d. 1063 (11th Cir. 2003).

[86] Id.

[87] Id.

[88] Browning-Ferris Indus. v. U.S., 233 F. Supp. 1223 (D. Ariz. 2002).

[89] Browning-Ferris Indus. v. U.S., 233 F. Supp. 1223 (D. Ariz. 2002)..

[90] Tax Equity and Fiscal Responsibilty Act of 1982, Pub. L. No. 97-248, § 402(a), 96 Stat. 324,648 (1982). IRC § 6221 through 6234.

[91] IRC §§ 6223 and 6224.

[92] Treas. Reg. §§ 301.6224(c) - 1(a)(2) & (c).

At the beginning of the audit, the Tax Matters Partner (TMP) and all notice partners and notice groups receive notice of the audit.[93] All notices, including those beginning administrative procedures and summarizing proposed adjustments (audit results), are sent to the TMP, who deals directly with the IRS on all partnership items.[94] The IRC specifically provides for the IRS to send a notice of final partnership administrative adjustment and conduct business with the appointed partnership representative known as the TMP on all partnership related adjustments.[95] Unless a non-notice partner is part of a notice group and requests the notice, this notice is only sent to notice partners and the TMP.[96] The TMP is required to keep non-notice partners informed and to forward notices.[97]

Therefore, if the TMP does not notify the non-notice partner of the IRS examination or the examination results, the non-notice partner will have no knowledge of the examination until he or she receives a bill from the IRS. Since the partnership agreement is binding on all non-notice partners, this partner has no option but to pay the amount due.

In four of the 11 partnership cases, *George v. Commissioner*,[98] *Monahan v. Commissioner*,[99] *Field v. United States*,[100] and *Beagles v. Commissioner*,[101] the taxpayers represented themselves, *pro se*. The IRS prevailed on all but two partnership income cases, in both of which the taxpayers were represented by counsel.[102]

Retirement Income

Thirteen cases dealt with retirement income, with three of them concerning distributions from Individual Retirement Accounts (IRA).[103] *Mills v. Commissioner*[104] involved an early withdrawal of an IRA based on bad advice from a bank. The taxpayer in this case was required under a court ordered domestic settlement agreement to withdraw a portion of

[93] IRC §§ 6223(a) & (b).

[94] Treas. Reg. § 301.6224(a)-1 & Treas. Reg. § 301.6224(b)-1.

[95] IRC §§ 6223 and 6224.

[96] IRC § 6223(a) & (b).

[97] IRC § 6223(g); Treas. Reg. § 301.6223(g)-1.

[98] George v. Comm'r, T.C. Memo. 2002-163.

[99] Monahan v. Comm'r, 321 F.3d 1063 (11th Cir. 2003).

[100] Field v. United States, 89 A.F.T.R.2d. (RIA) 2993 (S.D.N.Y. 2002), vacated & remanded, 328 F.3d. 58 (2d Cir. 2003); on remand, 92 A.F.T.R.2d. (RIA) 6929) (S.D.N.Y. 2003).

[101] Beagles v. Comm'r, T.C. Memo. 2003-67.

[102] Browning-Ferris Indus. V. United States, 233 F. Supp. 2d 1223 (D. Ariz. 2002); Tampa Bay Devil Rays Ltd v. Comm'r, T.C. Memo. 2002-248.

[103] Ancira v. Comm'r, 119 T.C. 135 (2002); Tussey v. Comm'r, T.C. Summ. Op. 2003-47; Mills v. Comm'r, T.C. Summ. Op. 2003-41.

[104] Mills v. Comm'r, T.C. Summ. Op. 2003-41.

his IRA and transfer it to his former wife. However, the taxpayer relied on oral advice from a bank employee who told him that he must withdraw the entire IRA. The Court held that the taxpayer was not a qualified payee[105] of the IRA proceeds under IRC § 72(t)(2)(C), and therefore the amount he received in excess of the required payment to his former wife was includible in income, and subject to the 10 percent early withdrawal penalty.[106]

In *Tussey v. Commissioner*,[107] the taxpayer represented herself and argued that she had relied on advice received over the telephone from one or more IRS employees. The taxpayer testified that an unnamed IRS employee told her that IRA distributions used to purchase a home were not taxable. The Court held that the IRA distribution was includible in income and subject to the 10 percent early withdrawal penalty.[108] The Court stated in *Tussey*, that "bad advice is not binding on the Commissioner,"[109] however, the taxpayer was not taxed on $10,000 of the distribution under the first time homebuyer exclusion of IRC § 72(t)(2)(F).[110]

In *Ancira v. Commissioner*,[111] the taxpayer had the option on how to invest his IRA funds. The taxpayer chose to invest in stocks, and purchased the stocks with funds from the IRA. The check to purcha argued a premature IRA distribution had occurred. However, the taxpayer did not negotiate the check, but instead mailed that same check to the company to purchase their stock. The taxpayer in this case was represented by counsel and the court concluded the stock certificates were owned at all times by the IRA and therefore a proper rollover had occurred.[112]

Four of the retirement income cases involved the taxability of Social Security benefits and the inclusion of these benefits in income.[113] The taxpayers in all four of these cases were *pro se*. The Court found in favor of the government in each case.

In *Leppin v. Commissioner*,[114] the Court found that it was unclear if the pension benefits were Tier 1 or Tier 2 railroad retirement benefits. The Railroad Retirement Board uses Form RRB 1099 to report Tier 1 benefits, which are equivalent to Social Security benefits,

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[105] IRC §§ 402(e) (1) (A) & 414(p).

[106] Mills v. Comm'r, T.C. Summ. Op. 2003-41.

[107] Tussey v. Comm'r, T.C. Summ. Op. 2003-47.

[108] Id.

[109] Tussey v. Comm'r, T.C. Summ. Op. 2003-47(citing Darling v. Comm'r, 49 F.2d 111, 113 (4th Cir. 1931), Fortugno v. Comm'r, 41 TC 316, 323-324 (1963) and Bagnell v. Comm'r, TC Memo. 1993-378).

[110] Tussey v. Comm'r T.C. Summ. Op. 2003-47.

[111] Ancira v. Comm'r, 119 T.C. 135 (2002), 3.

[112] Ancira v. Comm'r, 119 T.C. 135 (2002).

[113] Leppin v. Comm'r, T.C. Summ. Op. 2002-143; Mihok v. Comm'r, T.C. Summ. Op. 2002-157, Nicholas v. Comm'r, T.C. Summ. Op. 2002-77; and Helm v. Comm'r, T.C. Summ. Op. 2002-138.

[114] Leppin v. Comm'r, T.C. Summ. Op. 2002-143.

and Form RRB 1099-R to report Tier 2 benefits, which are equivalent to pension benefits.[115] The taxpayer represented himself at trial and provided a copy of his Form RRB 1099, which was blank, and Form RRB 1099-R showing amounts for pension distributions and employee contributions.[116] The Court concluded that the entire amount should be included as pension income.[117]

In *Nicholas v. Commissioner*,[118] the taxpayer contended that a portion of the social security disability benefits should be excluded because they were attributable to a 1997 work-related injury. A portion of the social security benefits included unpaid disability claims from prior years. The taxpayer did not report this portion of the benefits claiming they were excludable under IRC §105(d), which was repealed in 1984. Because the taxpayer did not make an election under IRC § 86(e), regarding a lump sum distribution, the court held the entire amount of social security disability benefits were includible in gross income.[119]

In *Mihok v. Commissioner*,[120] the taxpayer argued the overpaid social security benefits should be excluded from income because they had to be repaid to the Social Security Administration in subsequent years. The court rejected the taxpayers argument based on IRC § 86(d)(2)(A), which provides that social security payments shall be reduced by the portion of the benefits that have to be repaid in the year of repayment.[121]

Another case, *Helm v. Commissioner*,[122] involved the conversion to a Roth IRA and the tax impact of that conversion on the taxability of Social Security income. The taxpayers argued that instructions in determining taxable social security benefits exclude IRA rollovers, that their IRA conversion to a Roth IRA was a rollover, and therefore the conversion should not be included in determining the taxable portion of social security benefits. The taxpayers further argued that there was a significant difference between getting money and not getting it. In the case of a conversion from a regular IRA to a Roth IRA, they did not get the money. The Court disagreed with the taxpayers' position citing the plain language of the statute and the regulations.[123]

[115] Leppin v. Comm'r, T.C. Summ. Op. 2002-143(citing IRC §§ 86(a) (4), (d) (1) (B), & (d) (4)).
[116] Leppin v. Comm'r, T.C. Summ. Op. 2002-143.
[117] Leppin v. Comm'r, T.C. Summ. Op. 2002-143.
[118] Nicholas v. Comm'r, T.C. Summ. Op. 2002-77.
[119] Nicholas v. Comm'r, T.C. Summ. Op. 2002-77.
[120] Mihok v. Comm'r, T.C. Summ. Op. 2002-157.
[121] Mihok v. Comm'r, T.C. Summ. Op. 2002-157.
[122] Helm v. Comm'r, T.C. Summ. Op. 2002-138.
[123] Helm v. Comm'r, T.C. Summ. Op. 2002-138.

Attorney Fees and Non-Physical Personal Injury Awards or Settlements

Eight cases involved the taxation of settlement income. One of these cases was discussed under the analysis of disability income.[124] The remaining seven cases primarily involved whether the income was includible under IRC § 61 or was excludible under another section of the law. In *Raymond v. United States*,[125] however, the issue was whether attorney fees from non-personal injuries[126] were includible as part of the taxpayer's gross income from the settlement. In this case, the Court held that the portion of the settlement award for attorney fees was not income to the taxpayer.[127] The Court based its conclusion on several factors including the fact that the taxpayer did not have substantial control over the attorney fees awarded by the Court and the settlement was not a tax avoidance scheme.[128] Further analysis of the attorney fee issue reveals that at least two additional cases litigated in 2003 address the taxation of attorney fees in non-personal injury settlement cases.[129]

The taxation of attorney fees in non-personal injury cases was addressed in the 2002 National Taxpayer Advocate's Annual Report to Congress.[130] In cases reviewed for both this and the previous report, there was an inconsistency in the way income for settlements was reported based on the jurisdiction in which the taxpayer resided. Some appellate courts have permitted a taxpayer to exclude from gross income the portion of the nonphysical personal injury settlement or court award that is used to pay attorneys fees.[131] Other appellate courts have held the taxpayer must include the entire settlement

124 Forste v. Comm'r, T.C. Memo. 2003-103.

125 Raymond v. U.S., 247 F. Supp 2d. 548 (D. Vt. 2002).

126 Nonphysical personal injury cases are filed by victims of employment, race, sex, or age discrimination, breach of contract, or wrongful termination.

127 Raymond v. U.S., 247 F. Supp 2d. 548, (D. Vt. 2002).

128 Id.

129 Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003); Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003). These cases are not contained in the table of litigated cases for this section because they were filed after the June 30, 2003 analysis period.

130 See National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Revi. 12-2002), p 161-171, 262.

131 Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000); Cotnam v. Comm'r, 263 F. 2d 119 (5th Cir. 1959); Estate of Clarks v. US, 202 F.3d 854 (6th Cir. 2000); Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000).

132 Alexander v. IRS, 72 F.3d 938 (1st Cir. 1995); O'Brien v. Comm'r, 319 F.2d 532 (3rd Cir. 1963); Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000); Hukkanen-Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001); Baylin v. U.S., 43 F. 3d 1451 (Fed. Cir. 1995).

or court award in income.[132] Even where the court found that the entire amount of the settlement award was includible in income, the treatment of attorney fees varied based on the nature of the expenditure.[133]

Of the cases that were litigated in 2003, decisions made in both the Sixth and Ninth circuits varied from previous holdings made by these circuits.[134] In both *Banaitis v. Commissioner*[135] and *Banks v. Commissioner*,[136] the courts based their holdings on the state lien laws and the assignment of income doctrine[137] (whether the taxpayer had substantial control). Therefore, the taxpayer can have a different result for the treatment of attorney fees based on the state in which the court award originated.

Pro Se and Represented Taxpayers

Ninety-one cases, or 52 percent, were litigated without benefit of counsel, "*pro se*." The following shows a comparison of *pro se* cases to the total population of income issue cases analyzed.

TABLE 3.2.2, ANALYSIS OF CASES

TYPE OF TAXPAYER	NUMBER OF CASES	*PRO SE*			REPRESENTED		
		Decision for Taxpayer	Decision for IRS	Remanded	Decision for Taxpayer	Decision for IRS	Split Decision
Individual	138	2	86		6	41	3
Businesses	31	0	5	1	5	20	0
Estates	6	0	0		1	4	1
Total	**175**	**2**	**91**	**1**	**12**	**65**	**4**

[133] Baylin v. U.S., 43 F. 3d 1451 (Fed. Cir. 1995)(legal fees were considered a capital expenditure); Alexander v. Internal Revenue Service, 72 F.3d 938 (1st Cir. 1995); Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001)(taxpayer was required to deduct the attorney fess as a miscellaneous itemized deduction subject to adjusted gross income limitations); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000)(same); and Hukkanen-Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001)(same). Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001)(legal fees were non deductible personal expenses related payment of legal fees in a divorce settlement).

[134] Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003); Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003). These cases are not contained in the table of litigated cases for this section because they were filed after the June 30, 2003 analysis period.

[135] Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003).

[136] Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003).

[137] Lucas v. Earl, 281 U.S. 111, 114-15 (1930)(Court held that the taxpayer could not assign the income he had earned to his wife because the taxpayer had substantial control over the income).

CONCLUSION

The analysis of income cases highlighted the confusion many taxpayers face in determining what is included in income. The cases revealed that there was confusion as to what is excludable from income, specifically certain types of compensation for injuries or sickness.[138] Taxpayers were also confused about the reporting of disability income, including the distinction between social security benefits and retirement disability income.[139] Lack of counsel representation appeared to be a factor in both the retirement income and disability income cases, and the courts generally ruled in favor of the IRS.

Of the 13 retirement income cases reviewed, the taxpayer was represented by counsel in only one case, which was the only retirement income case that was decided for the taxpayer.[140] In the three disability cases, two taxpayers were represented by counsel and one was not;[141] that taxpayer lost the case.[142] Of the two taxpayers who were represented, one prevailed in full on the decision and the other received a decision for partial exclusion of the disability income.[143]

The inconsistency of deducting attorney fees in a nonphysical injury settlement or award was discussed in the 2002 National Taxpayer Advocate's Annual Report to Congress and continues to be an issue.[144] The issue involves the differences in reporting income from nonphysical personal injury related settlements. In some circuits the taxpayer must include the full amount of the settlement and subsequently deduct the attorney fees as a miscellaneous itemized deduction.[145] In other circuits, the taxpayer reports only the net portion of the settlement agreement, after deducting the attorney fees.[146]

The National Taxpayer Advocate proposed a legislative recommendation in the 2002 Report to eliminate the disparate results between the appellate courts.[147]

[138] Exclusions from Income IRC §§ 101 through 140.

[139] Laws v. Comm'r, T.C. Memo. 2003-21.

[140] Ancira v. United States, 119 T.C. 135 (2002).

[141] Miley v. Comm'r, T.C. Memo. 2002-236; Forste v. Comm'r, T.C. Memo 2003-103; Byrne v. Comm'r, T.C. Memo. 2002-319.

[142] Miley v. Comm'r, T.C. Memo. 2002-236.

[143] Forste v. Comm'r, T.C. Memo. 2003-103; Byrne v. Comm'r, T.C. Memo 2002-319.

[144] *See* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 262.

[145] Alexander v. Internal Revenue Service, 72 F.3d 938 (1st Cir. 1995); O'Brien v. Comm'r, 319 F.2d 532 (3rd Cir. 1963); Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000); Hukkanen-Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001); Baylin v. United States, 43 F. 3d 1451 (Fed. Cir. 1995).

[146] Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000); Cotnam v. Comm'r, 263 F. 2d 119 (5th Cir. 1959); Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000); Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000).

[147] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 160-171.

The analysis of litigated cases for 2003 indicates similar patterns of frivolous arguments and unreported income cases found in the analysis of litigated cases for 2002.[148] The cases reviewed showed taxpayers continue to employ tax arguments that have been repeatedly rejected by the courts.

The analysis of partnership income cases identified one opportunity to assist taxpayers in the audit process, which is the notice procedure in TEFRA cases where there are more than 100 partners. In these cases, only if the individual investor is part of a five percent group and requests notice will the group receive notice of the partnership audit and audit results.[149] The individual partner is bound by the decisions made at the partnership level by the TMP, and judicial review is limited.[150]

Potentially over five million taxpayers, or one-third of all partners, are affected by the limited notice requirements.[151] In the 2002 filing year, partnerships with over 100 partners filed 5.4 million Schedule K-1's, Partners' Share of Income, Credits, and Deductions, etc., with the IRS. Partnerships with fewer than 100 partners filed approximately 10 million Schedule K-1's with the IRS for the same period.[152]

The regulations allow for a non-notice partner to file an election not to be bound by any TMP settlement.[153] However, the taxpayer must be aware of the regulation and file the election. The IRS could include information about the election in the partnership instruction publications or a legislative change could provide such notices be sent to all partners, regardless of partnership interest. A legislative change requiring notice be sent to all partners could significantly reduce taxpayer burden and promote equity for all affected taxpayers, regardless of their percentage of partnership interest. Although the partnership agreement would continue to be binding on the partners, the individual partners would be informed the audit was taking place and the have the opportunity to participate in the proceedings. However, additional costs would be associated with the expanded number of notices.

The IRS compliance initiatives may contribute to an increase in the number of court cases in these income related areas. The following table shows the number of audit closures based on some of the various categories of returns being examined by the IRS.

[148] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 260.

[149] IRC § 6223(b)(2).

[150] IRC §§ 6227 & 6228.

[151] Electronic Tax Administration Business Master File Marketing Database, Annual Nationwide Analysis, SB/SE Research July 2003, p. 24.

[152] Electronic Tax Administration Business Master File Marketing Database, Annual Nationwide Analysis, SB/SE Research July 2003, p. 25.

[153] Treas. Reg. §§ 301.6224(c)-1(a)(2) and (c).

TABLE 3.2.3, IRS AUDIT CLOSURES SUMMARY FY 2001-2003[154]

Indicator	FY 2001	FY 2002	FY 2003
Non-filer Return Closures	36,293	38,108	39,063
Number of Flow Through Closures	18,429	20,997	30,377
• Number of Partnership Closures	2,610	3,093	4,475
• Number of Subchapter-S Corp. Closures	10,140	11,360	16,435
• Number of Trust Closures	5,679	6,544	9,467
Number of Employment Tax Closures	12,699	11,791	13,560
Number of Excise Tax Closures	9,880	7,542	8,326
Number of Estate and Gift Tax Closures	10,351	9,658	10,908

Although the table does not show all of the various categories of returns being examined by the IRS, the categories shown provide an indication of increased audit coverage in flow-through entities and non-filer returns.

[154] Strategy, Research and Performance Management (SRPM), SB/SE - Strategic Planning, Strategy and Program Plans http://sbse.web.irs.gov/SRPM/SRPMSPPDocs/.

LITIGATED
ISSUE #3

MOST LITIGATED ISSUE: TRADE OR BUSINESS EXPENSES

SUMMARY

Trade or Business Expense has been one of the ten most litigated tax issues in the federal courts for the last five years. Between June 1, 2002 and May 31, 2003, 55 cases were litigated that included a trade or business expense issue. An analysis indicates that the courts upheld the IRS position in 80 percent of the cases tried. The courts upheld the position of the taxpayer 11 percent of the time, and the remaining cases resulted in split decisions.

Travel and entertainment expense remains the primary issue litigated by taxpayers with sole proprietorships. Business entities, on the other hand, tend to challenge the IRS determination that certain expenses should be capitalized instead of written off as an expense in the year the item was purchased. Many cases tried by business entities also focus on whether an expense is ordinary and necessary for their business.

Overall, in 20 percent of the cases involving trade or business expense issues, taxpayers succeeded in full or in part. It is important for the IRS to continue providing education regarding this issue through outreach initiatives. Efforts in this area will only increase compliance and understanding of the laws regarding trade or business expense issues.

PRESENT LAW

Internal Revenue Code section 162(a) permits a taxpayer to deduct ordinary and necessary trade or business expenses paid or incurred during the taxable year.[1] These expenses include:

- Reasonable allowance for salaries or other compensation for personal services actually rendered;
- Travel expenses while away from home in the pursuit of a trade or business; and
- Rentals or other payments for use of property in a trade or business.[2]

[1] The taxable year in which a business expense may be deducted depends on whether the taxpayer uses the cash or accrual method of accounting. IRC § 446.

[2] IRC § 162 (a)(1), (2), and (3).

In addition to the general allowable expenses described above, IRC § 162 addresses deductible and non-deductible expenses incurred in carrying on a trade or business (e.g. illegal bribes, kickbacks, and other payments; fines and penalties; and special rules for health insurance costs of self-employed individuals).[3]

Internal Revenue Code section 162, is one of the Code's most fundamental provisions, allowing deductions for ordinary and necessary expenses in carrying on a trade or business. The interaction of IRC § 162 with other codes sections can become very complex. In fact, some code sections explicitly limit or disallow deductions permitted under IRC § 162's broad mandate. For example, the year in which the deduction for trade or business expenses can be taken depends on when the cost was paid or incurred, the useful life of an asset or when it is sold, or when the business operation is terminated.[4]

Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance (e.g., rulings and revenue procedures) that have developed over the years. The IRS, Congress and the courts continue to pose questions and provide legal guidelines about whether a taxpayer is entitled to certain trade or business deductions. The litigated cases analyzed for this report reveal that this process is ongoing. When a taxpayer seeks a re-determination of tax liability because the IRS has disallowed trade or business expenses, the courts must often address a series of questions before issuing decisions, including those discussed below.

What constitutes a trade or business as referenced in IRC §162?

"Trade or Business" is one of the most widely used terms in the Internal Revenue Code, but no definition appears in the Code or in any Treasury Regulation.[5] In *Commissioner v. Groetzinger*[6] the Supreme Court stated "...the Code has never contained a definition of the words 'trade or business' for general application, and no regulation has been issued expounding its meaning for all purposes. Neither has a broadly applicable authoritative judicial definition emerged."[7] The definition of "trade or business" comes from the so-called common law of federal income tax, concepts developed or defined by court decisions.[8]

[3] IRC § 162(c), (h), and (l).

[4] Itemized Deductions for Individuals and Corporations (e.g., IRC § 165 losses, IRC § 167 depreciation, and IRC § 183 activities not engaged in for profit) and inventories (IRC § 471, cost of goods sold).

[5] The term "trade or business" appeared in at least 492 subsections of the Code and 664 provisions of the regulations. F. Ladson Boyle, *What is a Trade or Business*, 39 Tax Law. 737 (1986).

[6] Comm'r v. Groetzinger, 480 U.S. 23 (1987).

[7] Id.

[8] Carol Duane Olson, *Toward A Neutral Definition of "Trade or Business," In The Internal Revenue Code*, 54 U. Cin. L. Rev. 1199 (1986).

What is an ordinary and necessary expense?

Ordinary and necessary business expenses are current business expenses that are paid or incurred during the taxable year and are fully deductible, as opposed to unreasonable expenses and capital expenditures. A current business expense must be both ordinary and necessary in relation to the taxpayer's trade or business.[9] In *Welch v. Helvering*,[10] the Supreme Court stated that the words "ordinary" and "necessary" have difference in meanings and in order to benefit the deduction both must be satisfied. In *Deputy v. Du Pont*,[11] the Supreme Court described an "ordinary" expense as customary or usual and is of common occurrence in the taxpayer's business. A "necessary" expense is described as appropriate and helpful for the development of taxpayer's business.

In addition to being ordinary and necessary, the courts have held that the amount of the expense must be reasonable. In *Commissioner v. Lincoln Elec. Co*,[12] 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."[13] Specific statutory language provides that salaries or other compensation for personal services actually rendered must be reasonable; and travel expenses incurred while away from home in pursuit of trade or business must not be lavish or extravagant.[14]

Is the expense a currently deductible expense or capital expenditure?

A currently deductible expense is an ordinary and necessary expense that is paid or incurred during the taxable year in carrying on a trade or business.[15] Examples of currently deductible expenses are management expenses, labor, supplies, incidental repairs, operating expenses of automobiles used in trade or business and traveling expenses while away from home solely in pursuit of trade or business.[16]

A capital expenditure is the amount paid for a new building or for permanent improvements that increase value or lengthen useful life, subject to certain exceptions.[17] As such, 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.[18] Instead, capital

[9] IRC § 162 (a).

[10] Welch v. Helvering, 290 U.S. 111 (1933).

[11] Deputy v. Du Pont, 308 U.S. 488 (1940).

[12] Comm'r v. Lincoln Elec. Co., 176 F.2d 815 (6th Cir. 1949).

[13] Comm'r v. Lincoln Elec. Co., 176 F.2d 815, 817 (6th Cir. 1949).

[14] IRC § 162(a)(1) and (2).

[15] IRC § 162(a).

[16] See Treas. Reg. § 1.162-1 for a more complete list.

[17] IRC § 263.

[18] INDOPCO, Inc. v. Comm'r, 503 U.S. 79 (1992).

expenditures may be subject to amortization, depletion, or depreciation over the useful life of the property.

Treasury Reg. §1.162-4 provides that "The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures."

Determining whether expenditures are deductible under IRC § 162(a) or must be capitalized under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach in applying principles of capitalization and deductibility.[19]

Can the taxpayer substantiate that the expense was paid or incurred during the taxable year?

Present law requires a taxpayer to maintain books and records that substantiate income, deductions and credits.[20] A taxpayer must keep adequate records to substantiate deductions claimed as trade or business expenses.[21] If a taxpayer is unable to substantiate deductions by documentary evidence (e.g. invoice, paid bill, or canceled check) but can establish that he had some deductible business expenditures, the Cohan rule may apply.

The *Cohan rule* is a rule of "indulgence" that was established by the United States Court of Appeals for the Second Circuit in its decision in *Cohan v. Commissioner*.[22] The Court of Appeals held "...the Board 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."[23] A taxpayer can argue entitlement to deduct business expenses under the Cohan rule but if he is unable to establish a reasonable basis for the expense, the Court is not compelled to follow the rule.

In certain instances, Congress has required specific and exact substantiation of expenses. For example, IRC § 274(d) requires strict substantiation of expenses for travel, meals and entertainment, and with respect to any listed property as defined in IRC § 280F(d)(4).[24]

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[19] *See* e.g., Norwest Corp. v. Comm'r, 108 T.C. 265 (1997) and PNC Bancorp, Inc. v. Comm'r, 212 F.3d 822 (3d. Cir. 2000).

[20] IRC § 6001; Treas. Reg. § 1.6001-1;Treas. Reg. § 1.446-1(a)(4).

[21] IRC § 6001; Treas. Reg. § 1.6001-1.

[22] Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930).

[23] Cohan v. Comm'r, 39 F. 2d 540, 544 (2d Cir. 1930).

[24] Listed property means any property that can be used for personal purposes including, 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 (as defined in section 168(i)(2)(B)), etc. IRC § 280F(d)(4)(A)(ii), (iii), & (iv).

A taxpayer is required to substantiate a claimed IRC § 274 (d) expense by adequate records or sufficient evidence corroborating the taxpayer's statement establishing the amount, time, and place and business purpose of the expense.[25] Even if such an expense would otherwise be deductible, the deduction may still be denied if there is insufficient substantiation to support it.[26]

Who has the burden of proof in a substantiation case?

When the Commissioner of Internal Revenue issues a notice of proposed deficiency to a taxpayer, it is presumed to be correct, and the burden is on the taxpayer to show that the proposed determination is incorrect. However, under certain circumstances, the burden of proof shifts to the Commissioner.[27]

Internal Revenue Code section 7491, Burden of Proof, was enacted as part of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).[28] Under the provisions of IRC § 7491(a)(1), if, in any court proceeding, a taxpayer introduces credible evidence with respect to his tax liability, the burden may shift to the Commissioner.[29] The taxpayer must satisfy these three requirements:

1. Comply with all substantiation and record keeping requirements in accordance with the applicable Internal Revenue Code section;
2. Cooperate with requests for witnesses, documents, meetings and interviews;
3. If the taxpayer is a partnership, corporation or trust, that taxpayer must meet the net worth requirements (less than $7 million) of IRC § 7430(c)(4)(A)(ii).[30]

ANALYSIS OF LITIGATED CASES

Trade or Business Expenses has been identified as one of the ten most litigated issues by taxpayers since the first edition of the National Taxpayer Advocate's *Annual Report to Congress* in 1998.[31] Fifty-five cases involving various trade or business expense issues were litigated in the federal court system during the period from June 1, 2002 through May 31, 2003. Table 3 in Appendix 2 contains a detailed listing of the cases.

[25] Treas. Reg. § 1.274-5T(b).

[26] Treas. Reg. § 1.274-5T(a).

[27] IRC § 6663, civil fraud is an exception to the Commissioner's presumed correctness. The burden of proof has to be carried by clear and convincing evidence. See IRC § 7454 and United States Tax Court Rule 142(b).

[28] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3001(a) & (c)(1), 112 Stat. 685, 726, 727 (1998).

[29] IRC § 7491(a)(1) applies to court proceedings 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.

[30] IRC § 7491(a)(2)(A) & (a)(2)(B), & (a)(2)(C).

[31] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104, (Revisions 12-1998 - 12-2002).

Seventy-three percent of the cases were brought by taxpayers with sole proprietorships and 27 percent involved business entities.[32] Sixty-two percent of the cases were filed in the United States Tax Court. The courts decided in favor of the IRS in 80 percent of the litigated cases. Thirty-three, or 60 percent, of the cases decided in favor of the IRS involved sole proprietorships, and 11 cases, or 20 percent, involved business entities.

SUMMARY OF ISSUES

Table 3.3.1 categorizes the significant issues raised by taxpayers in the cases litigated, many of which involved more than one item within a trade or business expense issue. To echo the relevant issues cited in each case, this table reflects the highlights of litigated issues and number of occurrences found in the case analysis. Therefore, each case may be taken into account in more than one category. For example, in *Bestor v. Commissioner*,[33] three significant trade or business expense issues were raised. The issues included travel and entertainment under IRC § 274(d), allowable deductions per IRC § 162 subject to the limitation under IRC § 280A, and ordinary and necessary trade or business expenses per IRC § 162. Therefore, *Bestor* would be considered in three categories.

[32] Sole proprietorships included taxpayers who filed Form 1040, Schedule C or Schedule E. Business Entities included taxpayers that filed Forms 1120, 1120S and 1065.

[33] Bestor v. Comm'r, T.C. Summ. Op. 2002-78.

TABLE 3.3.1, TRADE OR BUSINESS EXPENSE CASES & ISSUES

ISSUE	TYPE OF TAXPAYER	
	SOLE PROPRIETOR	BUSINESS ENTITY
Travel and Entertainment (IRC § 274(a))	19	2
Ordinary and Necessary Trade or Business Expenses (IRC § 162(a))	8	3
Substantiation of Expenses (IRC § 6001)	19	0
Various other applicable IRC sections[34]	6	5
Expense V. Capital Expenditure (IRC §162(a) v. §263(a))	4	3
Deduction of illegal bribes, kickbacks, or other illegal payments per IRC §162(c)(2)	1	0
Reasonable compensation per IRC §162(a)(1)	0	2
Allowable deductions per IRC § 162 and subject to limitation under IRC § 280A and IRC 280F	4	0
Business expense deduction under the claim of right doctrine per IRC § 1341	1	1

COURT DECISIONS

Table 3.3.2 reflects the number of favorable court decisions in each category.

TABLE 3.3.2, TRADE OR BUSINESS EXPENSE COURT DECISIONS

TYPE OF TAXPAYER	IRS	TAXPAYER	SPLIT decision	TOTAL CASES
Sole Proprietors	33	3	4	40
Business Entities	11	3	1	15
TOTALS	44	6	5	55

TAXPAYERS WHO ARE SOLE PROPRIETORS

There were 40 cases tried by taxpayers with sole proprietorships. Twenty-four, or 60 percent of these cases, were tried without the benefit of counsel, *pro se*. The court found in favor of the IRS in 19 or 79 percent of those cases. Forty-two percent of the sole

[34] Including: IRC § 163, 165, 174, 179, 401, 404, 446, 460, and 461.

proprietorship cases were filed electing the small case procedures in the Tax Court.[35] The IRS prevailed in 88 percent of the small tax cases.

The issue of trade or business expense litigated most by taxpayers who were sole proprietors was travel and entertainment expenses. Taxpayers claimed expenses for travel and entertainment as business related, although the expenses were personal in nature.

For example, in *Bestor v. Commissioner*,[36] the Court held that the taxpayer was not in a trade or business and was not entitled to a deduction. Additionally, the Court found that there was no evidence to support the taxpayer's assertions or the claimed deductions. The taxpayer did not keep any type of records such as a diary, or log book substantiating the mileage for his purported business travel. As a result, the Court held that the taxpayer was not entitled to deduct any car or truck expenses.

In cases such as *Jacobsen v. Commissioner*,[37] the Court found the taxpayer continued to challenge the IRS regardless of previous failed attempts regarding the same issue. In this case, the taxpayer claimed deductions for car and truck expenses, along with a deduction for meals and entertainment expenses. The court denied the deductibility of the car and truck expenses, as well as meal and entertainment expenses due to lack of substantiation as required under IRC § 274(d).[38] The taxpayer was on notice that he was required to maintain better records to substantiate business expenses because the taxpayer had previously lost a case involving the substantiation of business expenses in the Tax Court. The Ninth Circuit, prior to the year at issue, affirmed the Tax Court's opinion in the prior case.

The courts address the *Cohan* rule in most of the sole proprietorship cases. As discussed in the section entitled *Present Law*, the *Cohan* rule is applied when the taxpayer does not keep sufficient records to verify the amount of expenses reported on the income tax return. Generally, the court will estimate the amount of deductible expenses if the taxpayer can present a reasonable evidentiary basis to do so. The courts granted some expense deductions using "reasonable evidentiary basis" in only three of the decided cases.[39] However, the *Cohan* rule does not apply to expenses covered by IRC § 274(d). This section of law disallows any deduction for entertainment expenses when a taxpayer fails to substantiate the expense by "adequate records," or by "sufficient evidence" to

[35] See IRC § 7463. The term small case means a case in which the amount in dispute is $50,000 or less and in which the Court has concurred with the taxpayer's election. Tax Court Rules of Practice and Procedure, Rule 170. Trials conducted under the small case procedure are conducted as informally as possible with all proba tive evidence being admitted. Tax Court Rules of Practice and Procedure, Rule 174(b). There is no right to appeal the decision of the Tax Court in a case conducted under the small tax case procedures. IRC § 7463(b).

[36] Bestor v. Comm'r, T.C. Summ. Op. 2002-78.

[37] Jacobsen v. Comm'r, T.C. Summ. Op. 2002-87.

[38] Id.

[39] Boler v. Comm'r, T.C. Memo 2002-155; Guarna v. Comm'r, T.C. Summ. Op. 2003-65; and Blankson v. Comm'r, T.C. Summ. Op. 2003-12.

corroborate the amount of such expense, the time and place the expenditure occurred, the business purpose of the expense, and the business relationship of the person entertained.[40]

In the cases where the taxpayer could not substantiate deductions for travel and entertainment expenses, the *Cohan* rule was superseded by IRC § 274(d). For example, in *Johnson v. Commissioner*,[41] the Court stated, "[T]o support their deductibility, taxpayers are required to substantiate by adequate records or by sufficient evidence corroborating their own statements, the amount, time, place, and business purpose of the claimed expenses. The section 274(d) substantiation requirements supersede the Cohan rule making the Cohan rule generally inapplicable for expenses covered by section 274(d).

There were 19 litigated cases in which taxpayers with sole proprietorships claimed travel and entertainment expenses as part of their business expense deductions. None of the 19 taxpayers had adequate substantiation for the expenses. The courts denied the deductions and cited IRC § 274(d) as the basis of their determinations.

BUSINESS ENTITIES

Fifteen cases tried in court involved business entities in various industries, including:

- Real estate development company
- Accounting firm
- Gas station
- Trade-show designer
- Professional medical corporation
- Aluminum producer
- Videotapes distributor

The analysis indicates that business entities have a slightly better chance than sole proprietors of receiving a favorable outcome in all or part of the litigation regarding trade or business expense issues. This could be due to the fact that most business entities hire attorneys to represent them; whereas, most taxpayers with sole proprietorships did not hire attorneys, probably due to economic reasons.

Some of the issues litigated were:

- Redemption of company stock held in employee stock ownership plan (ESOP) as dividends paid pursuant to IRC § 404(k).[42]

[40] Treas. Reg. § 1.274-5T(c).

[41] Johnson v. Comm'r, T.C. Memo. 2002-239.

[42] Boise Cascade Corp. v. Comm'r, 329 F.3d 751 (9th Cir. 2003).

- Legal expense.[43]
- Reasonable compensation.[44]
- Interest payment on loans used to pay corporate owned employee life insurance premium.[45]
- Expense v. capital expenditure per IRC § 263(a).[46]

The top two issues are expense versus capital expenditure and reasonable compensation. Three cases addressed the issue of capital vs. currently deductible expenses, which resulted in mixed decisions. In *Vanalco, Inc. v. Commissioner*,[47] the court disallowed the deductions for expenses relating to replacing the cell linings of aluminum smelting machines and the removal and replacement of brick floors of the cell rooms. The court relied on the basic functional nature of the cell linings rather than the value added attributes in disallowing the current deduction for the replacement of the cell linings.[48] With respect to the floor removal and repair, the court relied on the added value of the floor for its decision to disallow the deduction as a current expense.[49]

In *Cinergy Corp. v. the United States*,[50] the court allowed the deduction on the cost of asbestos removal because the removal did not add value to the property or increase the useful life of the building. Even more importantly, it should be our charge to take special care in ensuring that the rights of *pro se* taxpayers in litigation are not dismissed simply due to the fact that the taxpayers have no legal counsel.

The court also took into account that the asbestos removal was neither prompted by any intent to sell the building nor considered as part of a major refurbishment program of the building.[51]

In *FRGC Inv., LLC v. Commissioner*,[52] the Court disallowed the abandonment loss claims because they were not ordinary and necessary but were capital in nature. This case involved a purchase of real estate that took three years with the final cost of $669,126, after two purchase agreement cancellations. The taxpayer claimed the costs incurred

[43] Capital Video Corp. v. Comm'r, 311 F.3d 458 (1st Cir. 2002)

[44] Haffner's Service Stations, Inc. v. Comm'r, 326 F.3d 1 (1st Cir. 2003); Devine Bros., Inc. v. Comm'r, T.C. Memo. 2003-15.

[45] Dow Chemical Co. v. United States, 250 F.Supp. 2d 748(E.D. Mich. 2003)

[46] Vanalco, Inc. v. Comm'r, 300 F.2d 1023 (9th Cir. 2002); Cinergy Corp. v. United States, 55 Fed Cl. 489 (2003): FRGC Inv., LLC v. Comm'r, T.C. Memo. 2002-276.

[47] Vanalco, Inc. v. Comm'r, 300 F. 3d 1023 (9th Cir. 2002).

[48] Id.

[49] Id.

[50] Cinergy Corp. v. United States, 55 Fed. Cl. 489 (2003).

[51] Id.

[52] FRGC Inv., LLC v. Comm'r, T.C. Memo. 2002-276.

during the first two purchase agreements qualified as abandonment losses even though the taxpayer ultimately purchased the same properties in the subsequent year. This taxpayer argued that the cancellation of escrow and discussions with the company's certified public account were enough events to prove abandonment. The court noted inconsistency in the finding after reviewing additional facts in the record. For instant, the taxpayer believed that the project was "dead" six weeks prior to the cancellation of the purchase agreement. In addition, taxpayer continued to pay fees to marketing and management services for overhead during the three-year period. The taxpayer did not notify the investors that the project would be abandoned in the issue year. In fact, the taxpayer did not meet with the investors until the following year when their approval was required to enter into the third and final purchase agreement.

TAX COURT SMALL CASE PROCEDURE

Seventeen of the cases were filed electing the small case procedure in the U.S. Tax Court. The remaining 38 cases were filed either as regular cases in the Tax Court (17), in the Court of Federal Claims (3), in a U.S. District Court (5), or as an appeal to the U.S. Circuit Courts of Appeal (13). In the small tax cases, the IRS prevailed 70 percent of the time and the taxpayer prevailed 12 percent of the time. The remaining 18 percent of the cases resulted in split decisions. The IRS prevailed 84 percent of the time in all cases other than small tax cases, and the taxpayer prevailed 11 percent of the time. The remaining five percent of the cases resulted in split decisions. Taxpayers with sole proprietorships filed all of the small tax cases. Based on these percentages, taxpayers with sole proprietorships appear to have a better chance of receiving a satisfactory outcome if they can try their cases as small tax cases.

TABLE 3.3.3, COMPARISON OF DECISIONS BY TYPE OF CASE

TYPE OF CASES	IRS	TAXPAYER	SPLIT DECISIONS	TOTAL CASES
Non-small Tax Court	32	4	2	38
Small Tax Court	12	2	3	17
TOTAL	44	6	5	55

CONCLUSION

Although the IRS continues to proactively educate taxpayers regarding this issue, the number of cases litigated remains steady. The analysis of cases indicates that taxpayers continue to challenge the IRS regarding their interpretation of the term trade or business expense, as well as the definition of ordinary and necessary. However, the courts do not always favor the IRS interpretation of the law. This is an indication that even the party that is charged with enforcement and education of all tax laws does not always correctly interpret the law, especially when the law is written in a subjective way.

Even though the law could be more explicit in defining the term trade or business expense and the term ordinary and necessary, advocating a specific legislative change that would provide definitions without any room for misinterpretation would be difficult.

As reported in the previous year's report, the legislative history of IRC §§ 162 and 274(d) indicates past efforts by Treasury, the President and Congress to curb abuse relating to improper deductions for meals and entertainment expenses.[53] An example of this is when Congress passed legislation to change the record keeping requirements for expenses subject to IRC § 274(d).[54]

The Internal Revenue Service should continue to take a proactive approach through education, outreach, and partnering with stakeholders. We must make the tax law easier to understand for individual taxpayers, especially *pro se* taxpayers, so that they will comply with their tax obligations and continue to stay in the tax system.

[53] In 1961, Treasury reported to Congress that widespread abuse was developing in the use of expense accounts. President Kennedy recommended disallowing business entertainment deductions, curtailing deductions for business travels and business gifts and limiting the amount of deduction for business meals. Revenue Act of 1962, S. REP. NO. 87-1881 (1962) reprinted at 1962-3 C.B. 707. These proposals were intended to prevent personal and extravagant expenses from being borne by the federal government (i.e., by other taxpayers). Instead, Congress enacted legislation that included strict substantiation requirements. In 1978, President Carter proposed a similar plan, calling for disallowance of all business entertainment deductions and restricting deductions of business meal expenses. Congress rejected this plan, deciding instead to limit deductions of expenses for entertainment facilities. In 1984, Treasury released its plan, proposing a complete denial of all deductions for entertainment expenses. See Wendy Gerzog Shaller, *Limit Deductions for Mixed Personal/Business Expenses: Curb Current Abuse and Restore Some Progressivity Into The Tax Code*, 41 Cath. U.L. Rev. 581 (1992).

[54] The Tax Reform Act of 1984, Pub. L. No. 98-369, § 179(b)(2), Stat., (1984) made three distinct changes to IRC § 274(d). It required taxpayers to keep contemporaneous records; it eliminated the ability taxpayers to offer written and oral testimony in lieu of records, and it added other forms of transportation to the list of property subject to the requirements of IRC § 274(d). In an attempt to improve compliance, Congress enacted two controversial retroactive changes to prior law. First, it made paid income tax preparers responsible for advising taxpayers of the substantiation requirements of IRC § 274(d) and to get written confirmation from the taxpayers that they met the requirements. The second change related to the negligence penalty; it would now be applied to any portion of an underpayment attributable to failure to comply with the record keeping requirements.

LITIGATED ISSUE #4

MOST LITIGATED ISSUE: ACCURACY-RELATED PENALTY FOR NEGLIGENCE

SUMMARY

Forty-one cases including the accuracy-related penalty for negligence or disregard of rules or regulations were litigated during the 12 months covered by our analysis. The penalty was not the primary issue in dispute, but was argued in association with the underlying tax deficiencies being contested. The IRS prevailed in whole or in part in 37 of the 41 cases on the penalty issue.

PRESENT LAW

The Internal Revenue Service promotes voluntary compliance, in part, by verifying the accuracy of tax return information through audits or examinations. During an examination, the IRS considers whether civil penalties related to accuracy should be assessed for various types of taxpayer misreporting, including negligence or disregard of rules or regulations.

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the tax laws, exercise ordinary and reasonable care in the preparation of a tax return, keep adequate books and records, or substantiate items properly.[1] Disregard of rules or regulations includes any careless, reckless or intentional disregard.[2]

IRS procedures state that the following may indicate negligence:[3]

- Unreported or understated income,
- Significantly overstated deductions or credits,
- Careless, improper, or exaggerated deductions,
- Misrepresenting or miscategorizing deductions in such a way as to conceal their true nature,
- Unexplainable items,
- Inadequately kept books and records,
- Cooperative state programs and state reports showing a negligence penalty (taking into account other factors and not relying entirely on the findings of another taxing agency),
- Substantial errors on an issue that had been adjusted in a prior year,
- Providing one's return preparer with incorrect or incomplete information,

[1] Treas. Reg. § 1.6662-3(b)(1).

[2] IRC § 6662(c); Treas. Reg. § 1.6662-3(b)(2).

[3] Internal Revenue Manual 20.1.5.7.1.

- Failure to report income shown on an information return,[4]
- Failure to make a reasonable inquiry into the correctness of a deduction, credit, or exclusion on a tax return that seems "too good to be true",[5] and
- Individual returns of partners or S corporation shareholders that are clearly inconsistent with the returns of the partnership or S corporation.[6]

The accuracy-related penalty for negligence or disregard of rules or regulations is 20 percent of the underpaid tax required to be shown on the taxpayer's return.[7] The penalty does not apply if the taxpayer has reasonable cause and acted in good faith, e.g., if an error was due to an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances.[8]

ANALYSIS OF LITIGTED CASES

Forty-one cases involving the accuracy-related penalty for negligence or disregard of rules or regulations, commonly referred to as the negligence penalty, were litigated in the federal court system from June 1, 2002, through May 31, 2003. A detailed listing of the cases may be found in Table 4 in Appendix 2. Twenty-four cases involved business income tax returns and the remaining 17 cases involved individual income tax returns. The business returns included 16 self-employed taxpayers filing Schedule C, Profit or Loss from Business; one taxpayer with rental properties filing Schedule E, Supplemental Income and Loss; two S corporations in which the taxpayer was the sole shareholder; and five C corporations.

The negligence penalty was not the primary issue litigated in any of the cases analyzed, but was considered in conjunction with the underlying tax deficiencies. The IRS prevailed in asserting the penalty in 32 cases, 18 of which involved business returns and 14 involved individual returns. The taxpayer successfully argued the negligence penalty was inappropriate in four cases, three involving business returns and one involving an individual return. In the remaining five cases, the IRS prevailed in asserting the negligence penalty on part of the deficiency and the taxpayer prevailed against the penalty on another part of the deficiency.

Our analysis identified a number of cases in which the taxpayer failed to keep adequate books and records to substantiate the positions taken on tax returns, resulting in assessment of the negligence penalty. The court found a lack of adequate books and records in

[4] Treas. Reg. § 1.6662-3(b)(1).

[5] Id.

[6] Id.

[7] IRC § 6662(a).

[8] Treas. Reg. § 1.6664-4(b)(1).

eight cases, all involving business returns.[9] The cases covered a variety of business activities including a used auto dealership claiming bad debt deductions for loan delinquencies and repossessed vehicles;[10] a real estate broker claiming Schedule C deductions including advertising, car, rent, and telephone expenses;[11] an attorney who operated multiple offices and failed to report gross income and could not substantiate business expense deductions;[12] and a sole proprietor who operated four separate businesses from his residence and claimed cost of goods sold, returns and allowances, and business expense deductions.[13]

The court found a lack of substantiation in another group of 13 cases involving individual returns where charitable contributions and/or employee business expenses had been fabricated by use of a formula offered by a tax return preparer.[14] The preparer declined to consider any documentation of the deductions his clients may have offered, advising them instead that substantiation of the deductions was not required. In general, the court found that because the taxpayers, individual and business alike, bore the burden of proof for their claimed deductions and lacked sufficient evidence to support them, the IRS had properly disallowed the deductions and asserted the negligence penalty.

We noted another trend in the defenses that taxpayers offered against the negligence penalty. Twenty-one taxpayers claimed that the penalty should not be assessed because they had relied on tax professionals in completing their returns.[15] In four of the cases analyzed, the courts found this defense was inadequate in whole or in part, because the

[9] Best Auto Sales, Inc. v. Comm'r, T.C. Memo. 2002-297; Heidrick v. Comm'r, T.C. Summ. Op. 2002-115; Johnson v. Comm'r, T.C. Memo. 2002-239; Montgomery v. Comm'r, T.C. Memo. 2003-64; Ngosso v. Comm'r, T.C. Summ. Op. 2002-154; Nunn v. Comm'r, T.C. Memo. 2002-250; Perrah v. Comm'r, T.C. Memo. 2002-283; and Saykally v. Comm'r, T.C. Memo. 02003-152.

[10] Best Auto Sales, Inc. v. Comm'r, T.C. Memo. 2002-297.

[11] Perrah v. Comm'r, T.C. Memo. 2002-283.

[12] Johnson v. Comm'r, T.C. Memo. 2002-239.

[13] Nunn v. Comm'r, T.C. Memo. 2002-250.

[14] Albach v. Comm'r, T.C. Summ. Op. 2002-85; Brown v. Comm'r, T.C. Summ. Op. 2002-91; Chambers v. Comm'r, T.C. Summ. Op. 2002-105; Cisneros v. Comm'r, T.C. Summ. Op. 2002-73; Fatta v. Comm'r, T.C. Summ. Op. 2002-99; Jaramillo v. Comm'r, T.C. Summ. Op. 2002-118; Lavigne v. Comm'r, T.C. Summ. Op. 2002-81; Pacheco V. Comm'r, T.C. Summ. Op. 2002-82; Parrett v. Comm'r, T.C. Summ. Op. 2002-72; Satriana v. Comm'r, T.C. Summ. Op. 2002-84; Wagner v. Comm'r, T.C. Summ. Op. 2002-97; White v. Comm'r, T.C. Summ. Op. 2002-70; and Wiley v. Comm'r, T.C. Summ. Op. 2002-116.

[15] Albach v. Comm'r, T.C. Summ. Op. 2002-85; Estate of Ballantyne v. Comm'r, T.C. Memo. 2002-160, aff'd 341 F.3d 802 (8th Cir. 2003); Blankson v. Comm'r, T.C. Summ. Op. 2003-12; Brown v. Comm'r, T.C. Summ. Op. 2002-91; Chambers v. Comm'r, T.C. Summ. Op. 2002-105; Cisneros v. Comm'r, T.C. Summ. Op. 2002-73; Fatta v. Comm'r, T.C. Summ. Op. 2002-99; Fowler v. Comm'r, T.C. Memo. 2002-223; Jaramillo v. Comm'r, T.C. Summ. Op. 2002-118; Lavigne v. Comm'r, T.C. Summ. Op. 2002-81; Middleton v. Comm'r, T.C. Memo. 2002-164; Neonatology Assoc.s., P.A. v. Comm'r, 299 F.3d 221 (3d Cir. 2002); Pacheco v. Comm'r, T.C. Summ. Op. 2002-82; Parrett v. Comm'r, T.C. Summ. Op. 2002-72; Perrah v. Comm'r, T.C. Memo. 2002-283; Satriana v. Comm'r, T.C. Summ. Op. 2002-84; Saykally v. Comm'r, T.C. Memo. 2003-152; Wagner v. Comm'r, T.C. Summ. Op. 2002-97; White v. Comm'r, T.C. Summ. Op. 2002-70; Wiley v. Comm'r, T.C. Summ. Op. 2002-116 and Williams v. Comm'r T.C. Memo. 2003-97.

taxpayer had not fully disclosed information to the preparer and/or the person consulted was not in fact a tax professional in a position to advise the taxpayer on tax matters.[16] The court did accept this defense in three cases, primarily after determining that the tax professional was indeed qualified to guide the taxpayer in the positions taken on the return. In the remaining cases, the court found that the taxpayers had not made adequate attempts to determine the preparers' qualifications to provide tax advice.[17] The same preparer, Robin Beltran, represented thirteen of these taxpayers.[18]

Mr. Beltran advised clients that records were not necessary to substantiate deductions claimed on the return, such as charitable contributions and unreimbursed employee business expenses, but that they were allowed the deductions based on a "formula." *Chambers v. Commissioner*[19] is representative of the court's response to these taxpayers in considering their defense against the negligence penalty:

> "Petitioners made no effort to ascertain the professional background and qualifications of their return preparer. They knew their claimed deductions were not based on the amounts they actually expended. That circumstance should have prompted petitioners to determine whether such representations by their return preparer were correct. They did not consult other tax professionals to verify the accuracy of the returns prepared by Mr. Beltran or the representations he made to them regarding their deductions....Petitioners, therefore, made no effort to assess their tax liabilities correctly."

Mr. Beltran was subsequently charged and pleaded guilty to helping prepare false federal income tax returns, facing up to three years in prison for each count and a fine of up to $250,000.[20] These cases underscore the need for each taxpayer to take reasonable steps in selecting a qualified return preparer and that taxpayers themselves are ultimately responsible for the entries on their returns. The National Taxpayer Advocate identified the challenge taxpayers face in assessing someone else's competency and expertise in tax

[16] Estate of Ballantyne v. Comm'r, T.C. Memo. 2002-160, aff'd 341 F.3d 802 (8th Cir. 2003); Middleton v. Comm'r, T.C. Memo. 2002-164; Neonatology Assoc.s., P.A. v. Comm'r, 299 F.3d 221 (3d Cir. 2002); and Williams v. Comm'r T.C. Memo. 2003-97.

[17] Albach v. Comm'r, T.C. Summ. Op. 2002-85; Brown v. Comm'r, T.C. Summ. Op. 2002-91; Chambers v. Comm'r, T.C. Summ. Op. 2002-105; Cisneros v. Comm'r, T.C. Summ. Op. 2002-73; Fatta v. Comm'r, T.C. Summ. Op. 2002-99; Jaramillo v. Comm'r, T.C. Summ. Op. 2002-118; Lavigne v. Comm'r, T.C. Summ. Op. 2002-81; Pacheco v. Comm'r, T.C. Summ. Op. 2002-82; Parrett v. Comm'r, T.C. Summ. Op. 2002-72; Perrah v. Comm'r, T.C. Memo. 2002-283; Satriana v. Comm'r, T.C. Summ. Op. 2002-84; Wagner v. Comm'r, T.C. Summ. Op. 2002-97; White v. Comm'r, T.C. Summ. Op. 2002-70; and Wiley v. Comm'r, T.C. Summ. Op. 2002-116.

[18] Albach v. Comm'r, T.C. Summ. Op. 2002-85; Brown v. Comm'r, T.C. Summ. Op. 2002-91; Chambers v. Comm'r, T.C. Summ. Op. 2002-105; Cisneros v. Comm'r, T.C. Summ. Op. 2002-73; Fatta v. Comm'r, T.C. Summ. Op. 2002-99; Jaramillo v. Comm'r, T.C. Summ. Op. 2002-118; Lavigne v. Comm'r, T.C. Summ. Op. 2002-81; Pacheco V. Comm'r, T.C. Summ. Op. 2002-82; Parrett v. Comm'r, T.C. Summ. Op. 2002-72; Satriana v. Comm'r, T.C. Summ. Op. 2002-84; Wagner v. Comm'r, T.C. Summ. Op. 2002-97; White v. Comm'r, T.C. Summ. Op. 2002-70; and Wiley v. Comm'r, T.C. Summ. Op. 2002-116.

[19] Chambers v. Comm'r, T.C. Summ. Op. 2002-105.

[20] The Associated Press, June 17, 2003, "Albuquerque man pleads guilty to tax charges."

matters in her 2002 Annual Report to Congress, and recommended that Congress enact a registration, examination, certification, and enforcement program for federal tax return preparers.[21]

In *Fowler v. Commissioner*,[22] the taxpayer avoided the imposition of part of the negligence penalty by disclosing on the return that he was taking a position contrary to rules or regulations. Fowler claimed a Schedule C business expense for interest paid to IRS for prior year tax deficiencies, and disclosed that position by filing Form 8275R, Regulation Disclosure Statement, with the return. Although the court held that the interest was not deductible, it did not sustain the assessment of the negligence penalty, because the position had been adequately disclosed.[23]

Twenty-five, or 61 percent, of the negligence penalty cases were litigated without the benefit of counsel, although the taxpayers named in two of these cases were attorneys themselves.[24] Fourteen of the *pro se* taxpayers, those who represented themselves, offered arguments that the court found frivolous and groundless.[25] Two of the 25 *pro se* taxpayers were successful in arguing against the negligence penalty, in whole or in part.[26]

In three of the 16 cases in which taxpayers were represented by counsel, taxpayers prevailed in their challenge to the negligence penalty.[27] Four others were successful in their arguments against the penalty on part of their deficiencies.[28] The remaining nine taxpayers represented by counsel were not successful in convincing the court that the penalty should not be applied.[29]

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[21] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 216.

[22] Fowler v. Comm'r, T.C. Memo. 2002-223.

[23] Id. at *12; see Treas. Reg. § 1.6662-3(c)(1).

[24] Johnson v. Comm'r, T.C. Memo. 2002-239 and Saunders v. Comm'r, T.C. Memo. 2002-143 aff'd 92 A.F.T.R. 2d (RIA) 6172 (6th Cir. 2003).

[25] Albach v. Comm'r, T.C. Summ. Op. 2002-85; Brown v. Comm'r, T.C. Summ. Op. 2002-91; Chambers v. Comm'r, T.C. Summ. Op. 2002-105; Cisneros v. Comm'r, T.C. Summ. Op. 2002-73; Hill v. Comm'r, T.C. Memo. 2003-144; Jaramillo v. Comm'r, T.C. Summ. Op. 2002-118; Jones v. Comm'r, T.C. Memo. 2003-131; Lavigne v. Comm'r, T.C. Summ. Op. 2002-81; Nunn v. Comm'r, T.C. Memo. 2002-250; Pacheco v. Comm'r, T.C. Summ. Op. 2002-82; Parrett v. Comm'r, T.C. Summ. Op. 2002-72; Satriana v. Comm'r, T.C. Summ. Op. 2002-84; Wagner v. Comm'r, T.C. Summ. Op. 2002-97; and White v. Comm'r, T.C. Summ. Op. 2002-70.

[26] Jahina v. Comm'r, T.C. Summ. Op. 2002-150 and Saunders v. Comm'r, T.C. Memo. 2002-143, aff'd 92 A.F.T.R. 2d (RIA) 6172 (6th Cir. 2003).

[27] Favia v. Comm'r, T.C. Memo. 2002-154; Fowler v. Comm'r, T.C. Memo. 2002-223; and Indeck Energy Services v. Comm'r, T.C. Memo. 2003-101.

[28] Estate of Ballantyne v. Comm'r, T.C. Memo. 2002-160, aff'd 341 F.3d 802 (8th Cir. 2003); Montgomery v. Comm'r, T.C. Memo. 2003-64; Peters v. Comm'r, T.C. Summ. Op. 2003-10; and Saykally v. Comm'r, T.C. Memo. 2003-152.

[29] Best Auto Sales, Inc. v. Comm'r, T.C. Memo. 2002-297; DAK, Inc. v. Comm'r, T.C. Summ. Op. 2003-52; Heidrick v. Comm'r, T.C. Summ. Op. 2002-115; Neonatology Assoc.s., P.A. v. Comm'r, 299 F.3d 221 (3d Cir. 2002); Ngosso v. Comm'r, T.C. Summ. Op. 2002-154; Pacileo v. Comm'r, T.C. Summ. Op. 2003-17; Perrah v. Comm'r, T.C. Memo. 2002-283; Rinehart v. Comm'r, T.C. Memo. 2003-109; and Williams v. Comm'r T.C. Memo. 2003-97.

As noted above, in 14 of the 41 cases involving the negligence penalty, the taxpayer advanced a position that the court found to be frivolous and groundless.[30] Internal Revenue Code § 6673(a)(1) authorizes the Tax Court to sanction a taxpayer when it appears to the court that the taxpayer has instituted or maintained proceedings primarily for delay, the taxpayer's position is frivolous or groundless, or the taxpayer unreasonably failed to pursue available administrative remedies. The Tax Court may impose a penalty of up to $25,000. The court imposed the § 6673(a)(1) penalty in 13 of the 14 "frivolous" negligence penalty cases.[31] In the remaining case, the court warned the taxpayer that the frivolous position penalty could be imposed if he persisted in using the arguments.[32]

CONCLUSION

The analysis of cases litigated during this reporting period indicates the most prevalent reason the negligence penalty was asserted and upheld is the lack of substantiation for claimed deductions. Taxpayers are not taking the care that is necessary to maintain adequate tax records.

The negligence penalty is considered for assessment only during the examination process. IRS examiners are directed to make every effort to apply penalties in a fair and consistent manner, and must have a legal basis for asserting the penalty.[33] IRS procedures require the examiner to discuss the penalty determination with the taxpayer, solicit the taxpayer's explanation, consider the reasonable cause exception, and document the penalty determination for potential managerial review with a list of the negligence indicators identified during the audit.[34]

The number of accuracy-related penalty assessments, including those for negligence or disregard of rules or regulations, has declined sharply since 1997. In fiscal year 2002, accuracy-related penalties were assessed in only 621 cases, down from 3,954 cases in 1997.[35] Prior to 1998, the IRS automatically assessed penalties and taxpayers did not necessarily know they could request abatements. Now, though fewer accuracy-related penalties

[30] "Frivolous" is defined as lacking a legal basis or legal merit; not serious; not reasonably purposeful. Black's Law Dictionary 535 (Abridged 7th ed. 2000). "Groundless" is defined as lacking reason or validity. *Black's Law Dictionary* 564 (Abridged 7th ed. 2000).

[31] In Hill v. Comm'r, T.C. Memo. 2003-144, the court asserted a $15,000 penalty and in Nunn v. Comm'r, T.C. Memo. 2002-250, the court asserted a $7,500 penalty. The court asserted a $500 penalty in the remaining cases: Albach v. Comm'r, T.C. Summ. Op. 2002-85; Brown v. Comm'r, T.C. Summ. Op. 2002-91; Chambers v. Comm'r, T.C. Summ. Op. 2002-105; Cisneros v. Comm'r, T.C. Summ. Op. 2002-73; Jaramillo v. Comm'r, T.C. Summ. Op. 2002-118; Lavigne v. Comm'r, T.C. Summ. Op. 2002-81; Pacheco v. Comm'r, T.C. Summ. Op. 2002-82; Parrett v. Comm'r, T.C. Summ. Op. 2002-72; Satriana v. Comm'r, T.C. Summ. Op. 2002-84; Wagner v. Comm'r, T.C. Summ. Op. 2002-97; and White v. Comm'r, T.C. Summ. Op. 2002-70.

[32] Jones v. Comm'r, T.C. Memo.. 2003-131.

[33] Internal Revenue Manual 4.10.6.4.

[34] Id.

[35] IRS Data Book, Publication 55B, (1997, Table 15) (2002, Table 26).

are assessed, they are better targeted. This may be attributed in part to the requirements of Internal Revenue Code section 6751, established by the Restructuring and Reform Act of 1998, which mandates approval of penalty assessments made after December 31, 2000 by the immediate supervisor of the individual making the penalty determination.[36] Verification of penalty determination improvements and reasons for the decline in accuracy-related penalty assessments would be a worthwhile issue to review.

[36] IRC § 6751 (b)(1), added July 22, 1998 by Pub. L. No. 105-206 for penalties assessed after December 31, 2000.

LITIGATED

ISSUE #5 MOST LITIGATED ISSUE: EARNED INCOME TAX CREDIT (EITC)

SUMMARY

The Earned Income Tax Credit (EITC) is the nation's largest need-based anti-poverty program.[1] Low income working families and individuals claimed over $36 billion in refundable credits in tax year 2002.[2] Potential EITC claimants, especially those with a qualifying child or children, must meet a complex set of requirements.

Thirty-one EITC cases were litigated in the federal court system during the period covered by our analysis. The issues in these cases related to EITC eligibility, disposition of the credit, or the treatment of the EITC in bankruptcy. More than half (16) of the cases involved residency rules for EITC taxpayers with qualifying children. Five others involved filing status determinations for married taxpayers. Another three cases turned on various eligibility tests for the credit other than residency, including relationship, age, and income level. Two cases were considered administrative or procedural in nature, based on the timeliness of the EITC claim or offset of the credit.

Five cases centered on the treatment of the EITC as property in a bankruptcy estate. A major focus in these cases was the court's characterizations of the EITC as a tax refund or public assistance.

Our analysis indicates that too many low income taxpayers continue to struggle to understand and comply with EITC requirements. This review of court cases reinforces findings that the National Taxpayer Advocate is attempting to address through administrative and legislative recommendations in her Annual Reports to Congress as well as ongoing systemic advocacy initiatives.

PRESENT LAW

The Earned Income Tax Credit (EITC) is a refundable federal income tax credit for low income working individuals and families.[3] Congress originally designed and approved the credit in 1975, in part to offset the burden of Social Security taxes and provide an incentive to work.[4] By inducing people who have families and receive public assistance to work

[1] In 2000, EITC payments went to 55.3 million persons. House of Representatives, Committee on Ways and Means, WMCP: 108-6, 2003 Green Book, Appendix K.

[2] EIC Report #701-98-11, IRS Wage & Investment Division Monthly Operating Review of EITC, July 2003.

[3] The EITC is sometimes called Earned Income Credit or EIC.

[4] S. Rep. No. 94-36 (1975). In 1975, recipients totaled 6.2 million and the average credit per family was $201. In 2002, recipient families totaled over 18 million and the average credit was $1,701. See *The Challenge of the EITC*, Philip Hamerlink, Tax Notes Today 160-28, August 18, 2003. See also IRS Tax Statistics at http://www.irs.gov/taxstats.

and thus support themselves, the EITC has achieved a measure of success.[5] In 1999, for example, the EITC is credited with lifting 4.7 million people (including 2.6 million children of low income workers) above the poverty threshold.[6]

The EITC reduces the amount of federal tax owed by those who claim and qualify for the credit. When the EITC amount exceeds the amount of taxes due, the taxpayer receives a refund. In tax year 2002, over 20 million taxpayers claimed more than $36 billion in credits.[7]

Working taxpayers with "earned income"[8] can qualify for the credit in one of two ways: either with a "qualifying child,"[9] or by "income-only."[10] For tax year 2002, the amount of EITC that could be claimed with a qualifying child or children ranged from $9 to $4140. The refundable credit ranged from $2 to $376 for taxpayers qualifying under the "income-only" rules.[11]

General EITC Eligibility

A taxpayer claiming the EITC must meet the following requirements:

- The taxpayer must have earned income.[12]
- The taxpayer must meet income thresholds, which vary according to how the credit is claimed.[13]
- The taxpayer must be a U.S. citizen or resident alien.[14]
- If married (as determined under IRC § 7703), the taxpayer must file a joint return.[15]

[5] Dennis Ventry, Jr., *The Collision of Tax and Welfare Politics, The Political History of the Earned Income Credit, 1969-1999*, The Brookings Institute, p. 19.

[6] U.S. Census Bureau, *Current Population Survey*, 2000.

[7] EIC Report #701-98-11, IRS Wage & Investment Division Monthly Operating Review of EITC, July 2003.

[8] IRC § 32(c)(2).

[9] IRC § 32(c)(3).

[10] IRC § 32(c)(1)(A)(ii).

[11] IRS Publication 596, *Earned Income Credit (EIC) 2002*, Earned Income Credit Table.

[12] IRC § 32(c)(2)(A). The definition of earned income was changed for tax years beginning on or after January 1, 2002 to include wages, salaries, tips and other employee compensation, but only if such amounts are includable in gross income for the taxable year, plus net earnings from self-employment. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 303, 115 Stat. 38. Previous rules required taxpayers to include taxable and non-taxable earned income in determining EITC eligibility.

[13] For tax year 2002, IRC § 32(a)(2) states that earned income could not exceed: $33,178 if the taxpayer claimed more than one qualifying child ($34,178 for married filing jointly), $29,201 if the taxpayer claimed one quali fying child ($30,201 for married filing jointly), or $11,060 if the taxpayer met "income only" qualifications per IRC § 32(b)(2).

[14] IRC § 32(c)(1)(E) & IRC § 32(c)(1)(D) states that the term "eligible individual" does not include any nonresi dent alien unless that person is treated as a resident of the United States for the taxable year, and does not include any individual claiming benefits of IRC § 911 (citizens or residents living abroad) for the taxable year.

[15] IRC § 32(d).

- The taxpayer must provide his or her taxpayer identification number (TIN);[16] if married, the TIN of the spouse is also required.[17] If the taxpayer has qualifying children, the taxpayer must provide the name, age and TIN of each child.[18]
- The taxpayer's investment income cannot exceed a specified amount.[19] For tax year 2002, investment income was capped at $2,550.[20]
- The taxpayer claiming the credit cannot be the qualifying child of another taxpayer.[21]

Additional Requirements for Taxpayers with Qualifying Child or Children

Additional requirements apply to taxpayers claiming the EITC who have one or more qualifying children:

- The children must meet age requirements.[22] A qualifying child must be under the age of 19 at the end of the tax year; or a student who has not reached the age of 24 at the end of the tax year;[23] or a child who, regardless of age, is permanently and totally disabled at any time during the tax year.[24]
- Qualifying children must meet a residency requirement.[25] The child or children must have the same principal place of abode as the taxpayer for more than one half of the taxable year. For tax years after 2001, the residency test for a foster child or children became more than one half of such taxable year instead of the entire year.[26]

[16] IRC § 32(c)(1)(F)(i). For the purposes of this provision, taxpayer identification number means social security number. See IRC § 32(m). There are several types of taxpayer identification numbers including Social Security Numbers (SSN), IRS Individual Taxpayer Identification Numbers (ITIN), IRS Adoption Taxpayer Identification Numbers (ATIN) and Employer Identification Numbers (EIN). Treas. Reg. § 301.6109-1.

[17] IRC § 32(c)(1)(F)(ii). For the purposes of this provision, taxpayer identification number means social security number. See IRC § 32(m).

[18] Id.

[19] IRC § 32(i) & IRC § 32(i)(2) Investment income for most taxpayers is the total of taxable interest, tax-exempt interest, dividend income, and capital gain net income..

[20] IRC § 32(i).

[21] IRC § 32(c)(1)(B).

[22] IRC § 32(c)(3)(C); also IRC § 32(c)(3)(A)(iii).

[23] IRC § 151(c)(4).

[24] IRC § 22(e)(3).

[25] IRC § 32(c)(3)(A)(ii).

[26] In prior years, the residency requirement for foster children was for the entire year, which still applies to older cases. This change was enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, Title III, § 303, 115 Stat. 38.

- Qualifying children must meet a relationship test.[27] In general, an individual meets the relationship test if the qualifying child or children are:
  - A son or daughter, stepson or stepdaughter, or a descendent of any such individual, or
  - A brother or sister, stepbrother or stepsister, or a descendant of any such individual whom the taxpayer cares for as his or her own child, or
  - An eligible foster child (i.e., an individual not described above who is placed with the taxpayer by an authorized placement agency and whom the taxpayer cares for as his or her own child).[28]
- If an individual (or individuals) is claimed as a qualifying child by two or more taxpayers for the same year, the taxpayer who is the parent of the qualifying child trumps all other individuals for eligibility. If both individuals are parents, the parent with whom the child resided for the longest period of time is the eligible individual. If the child resided with both parents for the same amount of time, then the parent with the highest adjusted gross income becomes the eligible individual.[29]

Additional Requirements for Taxpayers claiming EITC on "Income Only" Basis

The following are additional requirements for taxpayers claiming "income-only" EITC:

- The taxpayer must meet a residency test that requires the taxpayer's principal place of abode to be in the United States for more than one-half of the taxable year.[30]
- The taxpayer must meet an age requirement. The taxpayer, or if married, either the taxpayer or the spouse must be at least 25 years of age but less than 65 years of age before the close of the tax year.[31]
- The taxpayer cannot be a dependent (under IRC § 151) of another taxpayer in the same calendar year.[32]

[27] IRC § 32(c)(3)(B); also IRC 32 § (c)(3)(A)(i).

[28] IRC § 32(c) (3)(B).

[29] IRC § 32(c)(1)(C). Previously, the individual with the highest modified adjusted gross income for the taxable year was the eligible individual with respect to claiming the EITC. The prior year rules apply to tax years prior to 2002.

[30] IRC § 32(c)(1)(A)(ii)(I).

[31] IRC § 32(c)(1)(A)(ii)(II).

[32] IRC § 32(c)(1)(A)(ii)(III).

ANALYSIS OF LITIGATED CASES

Between June 1, 2002, and May 31, 2003, 31 cases were litigated in the federal courts to determine EITC eligibility, disposition of the credit, or the treatment of the EITC in bankruptcy.[33] A detailed listing of these cases is found in Table 5 in Appendix 2, which categorizes the cases by taxpayer, issues and other relevant data.

The 31 cases fall into five broad categories:

- Residency Requirements for the EITC With Qualifying Children
- Other EITC Eligibility Issues
- Married Person Filing Status for the EITC
- Administrative / Procedural Issues
- Disposition of the EITC in Bankruptcy

More than half (16) of the cases involved residency rules for EITC taxpayers with qualifying children. Five others involved filing status for married persons.[34] Three cases turned on various eligibility tests for the EITC other than residency, including relationship, age, and income level.[35] Two cases were considered administrative or procedural in nature, based on the timeliness of the claim or offset of the credit. Five others centered on the treatment of the EITC as property of a bankruptcy.[36]

Several of the cases illustrate the consequences of changes in EITC eligibility rules since tax year 2000, especially those regarding the definition of foster children.[37] Therefore, it is unlikely that several cases would have been litigated if current requirements for foster child eligibility had been in place.[38] For tax years after 2001, an eligible foster child must

[33] Last year in this section we included litigation affecting the EITC of minor or computational-based nature. Of the 52 EITC cases litigated in the federal court system that we reported on last year, 22 fell into those categories. We did not include these cases in this year's analysis because the EITC was a secondary issue and because changes to the EITC were merely a by-product of a tax litigation decision resulting in an adjustment to income, deductions or expenses.

[34] Married in this context means married for "tax purposes."

[35] IRC § 32(c)(3)(A). A child is a qualifying child of an individual if he or she meets three tests for relationship, residency and age.

[36] One of the cases was overturned on appeal.

[37] IRC § 32 (a)(c)(3)(ii). To qualify for the EITC, a child or children must have lived with a taxpayer for a period of time during the taxable year as specified by statute.

[38] *See*, e.g., Coats v. Comm'r, T.C. Memo. 2003-78. The Court found credible the testimony that the non-biological child lived with the taxpayer for nine months, but not for the entire year as required to meet the foster child residency test in the litigation year. In 2002, an eligible foster child must only live with the taxpayer for more than half the year to meet the residency test. In Dewald v. Comm'r, T.C. Sum. Op. 2002-75, the Court found the taxpayer resided with the foster children for 9-10 months and not for the entire year as required to meet the then-existing foster child eligibility standards.

only have lived with the taxpayer for more than half the year rather than for the entire year.[39]

More than 80 percent of the non- bankruptcy-related EITC cases (21 of 26), involved other family status tax credits and deductions as well. They included the dependency exemption,[40] head of household filing status,[41] and the Child Tax Credit (CTC).[42] The following chart depicts the specific breakdown:

TABLE 3.5.1, EITC CASE - ISSUES IN LITIGATION[43]

ISSUES IN LITIGATION	NUMBER OF CASES	PERCENTAGE OF TOTAL CASE POPULATION
EITC ONLY	5	19.2
EITC Dependent	6	23.1
EITC Dependent/Filing Status	14	53.8
EITC Dependent/Filing Status/CTC	1	3.8
EITC & Other Family Status Issues	21	80.8

In bringing multiple issues before the court, the cases highlight the interrelationship between the various tax credits and deductions for working families. The array underscores the challenges taxpayers face in establishing eligibility for each entitlement. That each requires a different set of rules, sometimes indistinguishable to the taxpayer, involving a range of income thresholds and differing age requirements compounds the confusion and burden for the taxpayer.[44]

General Observations

Tax law complexity causes taxpayers and IRS employees to err in determining eligibility, which results in the IRS withholding refunds, generating error notices, and issuing statutory notices of deficiency. In the fiscal year ended September 30, 2003, the IRS handled more than 400,000 EITC examinations.[45] The IRS typically withholds refunds while

[39] Beginning in tax year 2000, a new definition of foster child required that a child be placed with the taxpayer by an authorized placement agency.

[40] IRC § 152. The dependency exemption is a personal exemption applied to a dependent. For 2003, the exemption amount was $2,900. Eligible taxpayers must meet a support test.

[41] IRC § 2. Filing status issues generally involved changing head of household filing status to married filing separate. Head of household filing status entitles the taxpayer to favorable tax rates based on having paid over half the cost of keeping up a home for a child or other qualifying person for over half the year.

[42] The Child Tax Credit was enacted in 1997 to provide additional income support for families with children. The credit is now partially refundable for working individuals and families with dependent children up to age 17.

[43] The respondent may have conceded one or more of the issues prior to the court ruling on the issue.

[44] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), p. 76-127. See also, Child Tax Fairness Act of 2003, H.R. Rep No. 108-2718 (2003) and Tax Simplification Act of 2002, H.R. Rep No. 107-5166.

[45] IRS Report of Total EITC Closures W:CP:RC-PMA, dated October 16, 2003.

EITC examinations are pending. These cases can extend for months and sometimes more than a year, causing taxpayers to petition the U.S. Tax Court to resolve the EITC issue.

Summary of Key Indicators

A review of the 31 cases litigated in the federal courts in which the EITC was a substantive issue suggests a variety of reasons why taxpayers petition the court. As noted, in more than 80 percent of the non-bankruptcy EITC-related litigated cases, dependency exemptions, filing status, the Child Tax Credit, or a combination of these factors were key issues in addition to the EITC.[46] Approximately one-third of these cases (31 percent) resulted in split decisions in which the taxpayers prevailed, in part, by establishing entitlement to at least one family status credit or deduction argued before the court.

Court Decisions and Representation

In 24 of the 31 cases tried (77 percent), taxpayers represented themselves, *pro se*. In the seven remaining cases (23 percent), taxpayers had the assistance of attorneys. Analysis of the resulting decisions (see chart following) was inconclusive as to whether taxpayers fared better with representation, primarily because cases in which the taxpayer were represented involved matters considerably different in scope than the *pro se* cases that turned on EITC eligibility rules.

TABLE 3.5.2, LITIGATED DECISIONS - *PRO SE* VS. REPRESENTED

	Pro Se		Attorney	
For IRS/Government	13	54%	4	57%
For Taxpayer	3	13%	1	14%
Mixed Decision	8	33%	2	29%
Total Cases	24	100%	7	100%

Taxpayers did not have representation in any of the cases in which EITC eligibility rules were at issue. In contrast, in all of the cases involving administrative or procedural matters and in the bankruptcy cases involving the disposition of the credit, attorneys represented the taxpayer.

Residency Requirements for the EITC With Qualifying Children

Residency was the most contentious aspect of EITC eligibility before the court.[47] In more than half the cases, eligibility turned on whether the taxpayer and the qualifying

[46] The five bankruptcy-related cases revolved strictly on whether the EITC refund was an asset of the bankruptcy estate.

[47] IRS EITC examinations have shown that taxpayers often have difficulty in substantiating residency because they may struggle with the language; may be confused or unsure about what documentation or combination of documents they need to produce; or may be unable to meet IRS standards of responsiveness.

child lived together for more than half the year. Taxpayers were unsuccessful in showing they met the residency test for the EITC in 12 of the 16 cases reviewed. In two of the four cases in which the taxpayers met the test, the taxpayers did not prevail with respect to eligibility for the EITC for reasons other than residency.[48] Taxpayers acted *pro se* in all 16 of these cases.

In one case where the taxpayer was successful, the taxpayer was granted joint custody of the children.[49] The taxpayer testified that although the divorce decree provided for equal custody, his children lived with him for several weeks when they were supposed to reside with their mother. The Court held that the taxpayer had demonstrated that his children lived with him for more than the required six months of the year.

In a second case, school records showed the children lived with the mother and the IRS determined in examination that she, and not the taxpayer, was the custodial parent. The taxpayer was denied the EITC based on residency and subsequently litigated the issue. Court testimony supported the taxpayer's position that he, not the mother, was the custodial parent.[50]

These two cases illustrate the difficulties taxpayers face in overcoming what appears to be clear-cut evidence of residency. In both cases, testimony provided in court was dispositive[51] in establishing that the taxpayer and qualifying child lived together for the required time. The cases show that if the IRS becomes more willing to accept substantiation of residency outside the scope of traditional or systemic proof, these cases (and others like them that may follow) need not be litigated.

Other EITC Eligibility Issues

In addition to the residency test for EITC eligibility, taxpayers with qualifying children must satisfy rules that cover relationship and age. Further, a taxpayer's income must fall within established parameters depending on the number of qualifying children claimed. A taxpayer's earned income must be less than established parameters depending on whether one or two children are claimed.[52] Eligibility for the EITC hinged on these requirements in three of the cases reviewed.

[48] In one case, Coats v. Comm'r, T.C. Memo 2003-78, the taxpayer met the residency test, but because the qualifying child was deemed a foster child and not the biological child of the taxpayer under the relationship test, a full year of residence was required but not attained. In another case, Carter v.Comm'r. T.C. Summ. Op. 2002-107, the taxpayer met the residency test but did not prevail because of the tiebreaker rule that granted the EITC to another taxpayer in the household with the higher gross income.

[49] Meier v.Comm'r, T.C. Summ. Op. 2002-131

[50] Gingrich v.Comm'r, T.C. Summ. Op. 2002-158

[51] "Being a deciding factor; bringing about a final determination." *Black's Law Dictionary*, 484, (7th Ed.1999).

[52] Taxpayers may also claim the EITC without a qualifying child, but the amount of the credit is limited. For tax year 2002 it was capped at $376.

One case involved the relationship test for foster children and a rule change in tax year 2000, requiring that foster children be placed by authorized agencies in order to qualify.[53] The taxpayer resided with the children's mother and cared for the children in their home as his foster children for the prior nine years. He had claimed and received the EITC over that period. The taxpayer testified that if he married the children's mother, she would become ineligible for financial assistance for her disabling medical condition. The State refused to make a formal placement of the children in his home because of the taxpayer's living arrangement with the mother.[54] Here, the EITC rule change resulted in disallowance of the credit for which the taxpayer had been qualified for years.[55] This case demonstrates how rule changes can result in taxpayer burden and confuse taxpayers who attempt to comply with the rules.

One case involving other EITC eligibility rules turned on the amount of earned income that a taxpayer received from self-employment.[56] Since the EITC is a refundable credit, the IRS is sensitive to taxpayers who may inflate self-employment income to maximize their refunds. In this case, however, the taxpayer provided credible evidence during trial to support her earnings and was awarded the EITC as claimed. It is unclear whether the evidence was available before trial enabling the parties to settle the case without litigation.

Married Person Filing Status for the EITC

Married taxpayers must file a joint tax return to be eligible for the EITC. They cannot use the Married Filing Separately (MFS) status. Nonetheless, a taxpayer who is not living with his or her spouse for more than the last six months of the tax year may be considered not married for tax purposes.[57] Further, under certain circumstances, a taxpayer in this situation may be able to file as Head of Household (HOH). In either of these cases, the taxpayer may be eligible for the EITC.[58]

Five taxpayers claimed HOH filing status, but in all five cases, the court found that the proper filing status was MFS and denied the taxpayers eligibility for the EITC. While it may be easy to "write off" these cases as simply brought by misguided taxpayers, a more careful reading shows them to be indicative of the struggles some low income taxpayers

[53] Hegwood v.Comm'r, T.C. Summ. Op. 2002-156

[54] The Court noted that a majority of other States would find the taxpayer's living arrangement legitimate for purposes of licensed placements. Hegwood v. Comm'r,T.C. Summary Opinion 2002-156, p 4.

[55] IRC § 32(c)(3) as amended by the *Ticket to Work and Work Incentives Improvement Act of 1999*, Public Law 106-170, section 612(a), 113 Stat.

[56] Sliwinski v.Comm'r, T.C. Summ. Op. 2003-49.

[57] IRC § 7703(b).

[58] IRC § 2 (b). The taxpayer must meet certain residency and support tests.

face in literacy and comprehending tax terminology such as "head-of-household" filing status.[59] To some extent, these cases also reflect the difficulty that low income taxpayers have in adapting their non-traditional living arrangements to the tax laws. The fact that none of these taxpayers had the assistance of an attorney also may have impacted the outcome of the proceedings.

Administrative/ Procedural Issues

Two cases fit into the category of EITC administrative and procedural issues. In one case, a taxpayer sought to distinguish the EITC from income tax for the purpose of timeliness of a claim for refund.[60] The taxpayer contended that IRC § 6513 does not apply to the EITC portion of the refund because it does not explicitly mention the credit. The taxpayer argued that the EITC is more akin to a "remittance made by the government to the taxpayer" and as such, should be characterized as different from an income tax overpayment.[61] The taxpayer did not prevail in this case. In its ruling, the court relied on the Sorenson case, treating the EITC as similar to withholding taxes for the purposes of determining the timeliness of the claim.[62]

In a second case the tax court determined that it was appropriate for the IRS to offset the taxpayer's refund, which included the EITC, because IRC § 6402 specifically provides for the offset the overpayments, which under IRC § 6402 includes refundable credits, to any outstanding taxpayer liability.[63]

Disposition of the EITC in Bankruptcy

Five of the reviewed litigated cases were bankruptcy-based.[64] Jurisdiction in each case arises either in initial litigation in a United States Bankruptcy Court or on appeal in a United States District Court.

[59] In seventeen cases, taxpayers claimed Head of Household filing status in their Tax Court petition. See, e.g., Barrie v. Comm'r, T.C. Summ. Op. 2002-80.

[60] Israel v. United States, 91 A.F.T.R.2d (RIA) 1934 (D. Conn. 2003).

[61] IRC § 6513 addresses the date on which a return is deemed filed and provides that "any tax actually deducted and withheld at the source during the calendar year...shall, in respect of the recipient of the income, be deemed to have been paid by him on the 15th of the fourth month following the close of his taxable year."

[62] In Sorenson v. Sec'y of Treasury, 475 U.S. 851 (1986), the Supreme Court determined that the taxpayers' refund, a portion of which was attributable to the earned income tax credit, was considered an overpayment of tax. IRC § 6402(c) required the Internal Revenue Service to reduce the amount of any overpayment by the amount of any past-due child support payments assigned to the State. Because the EITC refund is considered an overpayment of tax, the lower courts correctly determined that it was proper for the IRS to intercept the refund and pay a portion of it over to the State of Washington for past-due child support payments.

[63] Trent v.Comm'r, T.C. Memo. 2002-285. In Sorenson v. Sec'y of Treasury, 475 U.S. 851 (1986) the Supreme Court determined that the earned income tax credit was an overpayment for purposes of IRC § 6402.

[64] Flannery v. Mathison, 289 B.R. 624 (W.D. Ky. 2003) rev'g Duvall Demars, 279 B.R. 548 (Bankr. W.D. Mo. 2002); Sharp, 286 B.R. 627 (Bankr. E.D. Ky. 2002); Duvall, 281 B.R. 646 (Bankr. W.D. Ky. 2002);, 281 B.R. 646 (Bankr. W.D. Ky. 2002); Tomczyk, 295 B.R. 894 (Bankr. D. Minn 2003).

In these cases, eligibility for or applicability of the EITC was not in dispute. Rather, in each case the debtor (referred to here as taxpayer) claimed the EITC portion of the tax refund as exempt property. In contrast, the trustee took the position that the federal income tax overpayments, including that portion associated with the EITC, were property of the debtor's bankruptcy estate, and were not exempt.

Under federal bankruptcy law, EITC refunds that arise prior to the filing of the bankruptcy petition are property of the bankruptcy estate.[65] However, debtors are allowed to exempt certain property. The Bankruptcy Code sets forth a list of default exemptions, but also allows states to "opt out" of them in favor of their own state law exemptions.[66]

A number of state exemption statutes allow a taxpayer to protect certain assets or benefits that inure from public assistance or are benefits otherwise based on need. The issue of disposition of the EITC portion of a federal tax refund has received considerable attention because courts have recently held that the EITC refund is in the nature of public assistance benefits, thereby properly treated as an exempt asset under the state bankruptcy exemptions, rather than as a tax refund, which is includable in the bankruptcy estate.

The disposition of the EITC refund in federal bankruptcy remains the subject of disparate treatment among jurisdictions. For example, in a bankruptcy case in Missouri, the taxpayer was not allowed to claim an exemption for the EITC refund.[67] By contrast, in two Kentucky cases, the EITC refund was considered exempt property for purposes of bankruptcy proceedings.[68] One of these Kentucky cases originally did not allow the EITC refund as exempt property, but was overturned on subsequent appeal.[69] Judge Joseph H. McKinley, Jr, of the U.S. District Court for the Western District of Kentucky opined that, "[While there is no binding precedent, Supreme Court or otherwise, on the issue, the modern trend among courts is that EITCs fall within the classification of public assistance.]"[70]

A bankruptcy case in Minnesota ruled the EITC refund was exempt property, but found the balance of the federal refund not exempt.[71] In another case[72], the IRS (as government

[65] 11 USCS § 541(a)(1)(2003). The estate is comprised of all legal or equitable interest of the debtor in property, wherever located, as of the commencement of the case. See also Williamson v. Jones, 224 F.3d 1193 (10th Cir. 2002)(earned income credit held property of the estate); Johnston v. Hazlett, 209.F.3d 611 (6th Cir. 2000)(earned income credit is part of the bankruptcy estate).

[66] 11 U.S.C. § 522(2003).

[67] In re Demars, 279 B.R. 548 (Bankr. W.D. Mo. 2002).

[68] Flannery v. Mathison, 289 B.R. 624 (W.D. Ky. 2003); Sharp, 286 B.R. 627 (Bankr. E.D. Ky. 2002)

[69] In re Duvall, 281 B.R. 646 (Bankr. W.D. Ky. 2002), rev'd, Flannery v. Mathison, 289 B.R. (W.D. Ky. 2003).

[70] Flannery v. Mathison, 289 B.R. (W.D. Ky. 2003).

[71] In re Tomczyk, 294 B.R. 894 (Bankr. D. Minn 2003).

[72] In re Sharp, 286 B.R. 627 (Bankr. E.D. Ky. 2002).

creditor in the proceedings) sought relief from the automatic stay[73] to exercise its right of set off against a tax refund, a portion of which was attributable to the EITC.[74] The bankruptcy court did not allow the IRS to setoff that portion of the tax refund attributable to the EITC, relying on prior determinations that under Kentucky law, the EITC was in the nature of a public assistance benefit.[75]

CONCLUSION

The foregoing analysis demonstrates how complicated it is for both taxpayers and IRS employees to determine EITC eligibility. Many of the findings serve to confirm problems that prior Annual Reports to Congress, Taxpayer Advocate Service systemic advocacy initiatives, and pending legislation are attempting to address.[76] Some EITC cases are litigated because of legitimate interpretive and factual disputes. However, this analysis makes clear that all too many low income taxpayers struggle to determine and establish EITC eligibility. Even when they are entitled to the EITC, they may not be able to obtain the credit without seeking judicial intervention.

Overall, the analysis points to considerable confusion regarding the numerous and sometimes conflicting eligibility rules. One strategy to administratively improve the EITC may incorporate expanded outreach and education, an approach discussed in detail in the Most Serious Problems section of this report. The National Taxpayer Advocate has, among other initiatives, proposed legislation that would reduce taxpayer burden, lessen complexity, and move toward a simplified and fairer administration of these intricate portions of the tax code.[77] Members of Congress have introduced several bills that would enact some or all of these proposals.[78]

[73] Under 11 U.S.C. § 362(a), the filing of a bankruptcy petition under any chapter operates as an automatic stay of eight specifically enumerated types of actions against the debtor, the debtor's property, or the prop erty of the bankruptcy estate. The scope of the automatic stay is very broad and generally prohibits actions that are attempts to enforce or collect a prepetition claim. The stay also generally prohibits actions that would affect or interfere with property of or in the custody of the estate, or property of the debtor. *Collier on Bankruptcy* p. 362.01 (Alan N. Resnick & Kevin J. Simon, eds. 15th ed. rev. 2003).

[74] 11 U.S.C. § 553 preserves the right of set-off a creditor has under non-bankruptcy law. The IRS right of set off is found in I.R.C. § 6402.

[75] In re Sharp, 286 B.R. 627 (Bankr. E.D. Ky. 2003).

[76] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), p. 76, and National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 47-94.

[77] In the 2001 Report to Congress, the National Taxpayer Advocate recommended legislative changes to reduce taxpayer burden and simplify the tax code in the area of family status. Among the recommendations included, creating a uniform definition of a qualifying child, removing means-tested public assistance and other government benefits in the computation of support, requiring a "voluntary" release of exemptions by custodial parents, and eliminating the age restrictions for taxpayers claiming Earned Income Tax Credit with no qualifying child. National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), p. 76.

[78] See e.g., Individual and Small Business Tax Simplification Act of 2003. H.R. 22, 108th Cong. (2003), *Tax Simplification Act of 2002*, H.R. Rep No. 107-5166 (2002).

A cross-functional team within the IRS, is identifying items and information that will help eligible taxpayers qualify for the EITC by providing clearer guidance on how taxpayers can fulfill and document relationship and residency requirements.[79] Administrative changes in the documentary evidence required to prove residency will enable taxpayers to substantiate their claims and resolve issues without having to litigate.

[79] IRS News Release, "IRS Announces Steps to Improve EITC Administration, Seeks Public Comment, " IR 2003- 78 (June 13, 2003), available at http://www.irs.gov/newsroom/index.html.

LITIGATED

ISSUE #6 MOST LITIGATED ISSUE: FAILURE TO FILE PENALTY

SUMMARY

Thirty-one cases involving disputes of the failure to file penalty were litigated in the federal courts during the period covered by our analysis. The failure to file penalty was a collateral issue in all but two instances. The IRS prevailed in all but one case, where the taxpayer was found to have demonstrated reasonable cause for the failure to file timely income tax returns.

Our analysis did not result in any new legislative or administrative recommendations. However, the National Taxpayer Advocate continues to support her previous recommendation: to broaden the definition of reasonable cause for the failure to file timely tax returns to include taxpayers with a history of compliance who make one-time inadvertent errors.

PRESENT LAW

Our tax system relies on the willingness of taxpayers to voluntarily report their income, file returns, and pay their taxes. The system incorporates penalties to accomplish several goals, primarily to encourage voluntary compliance and ensure that those who do not comply are justly held responsible.

A taxpayer that fails to file a tax return on or before its due date is subject to a late filing penalty. The penalty is five percent for each month or part of a month the return is not filed, up to a maximum of 25 percent.[1] The penalty is based on the net amount of tax due, which is the tax shown on the return minus any credits the taxpayer is entitled to claim and any payments made by the due date.[2]

If a taxpayer is more than 60 days late in filing, the minimum late filing penalty is either $100 or 100 percent of the unpaid tax due, whichever is smaller.[3] The penalty is mandatory unless the taxpayer can show the failure to file is due to reasonable cause and not willful neglect.[4] To prove reasonable cause, a taxpayer must show that he or she exercised ordinary business care and prudence but nevertheless could not file the return when it was due.[5]

[1] IRC § 6651(a)(1).

[2] IRC § 6651(b)(1).

[3] IRC § 6651(a).

[4] IRC § 6651(a)(1).

[5] Treas. Reg. § 301.6651-1(c)(1).

The failure to file penalty generally applies to individual, corporate, estate, gift, and excise tax returns.[6] The failure to file penalty for partnership returns is based on different criteria.[7]

ANALYSIS OF LITIGATED CASES

Thirty-one cases involving the failure to file penalty were litigated in the federal court system from June 1, 2002, through May 31, 2003. A detailed listing of the cases may be found in Table 6 in Appendix 2. Fifteen cases involved individual tax returns and 16 dealt with business returns. The business returns included 12 self-employed taxpayers filing Schedule C, Profit or Loss from Business; three corporations in which the taxpayer was the sole shareholder; and one corporation in which the shareholder ownership was not stated.

In 10 of the 31 cases, the taxpayer did not file a return at all. In three cases the taxpayer filed, but the return indicated zero income and expenses. One taxpayer disclosed only her name, address, and Social Security number. In the remaining 17 cases in which taxpayers did file returns, the filing delays ranged from one month to almost four years. The IRS assessed the maximum failure to file penalty, which is reached once a return is five months late, in 25 cases;[8] the minimum penalty of $100 in one case;[9] and percentages based on returns being one to three months late in two cases.[10] The remaining three cases did not include enough information to determine the number of months for which the failure to file penalty was assessed.[11]

[6] IRC § 6651(a)(1).

[7] IRC § 6698 provides a penalty for failure to file a partnership return of $50 times the number of persons who were partners in the partnership during any part of the taxable year, for each month (or fraction of a month) the failure continues (not to exceed five months), unless the failure is due to reasonable cause.

[8] Cabirac v. Comm'r, 120 T.C. 163 (2003); Hill v. Comm'r, T.C. Memo. 2003-144; Spurlock v. Comm'r, T.C. Memo. 2003-124; Hilvety v. Comm'r, T.C. Memo. 2003-119; Maher v. Comm'r, T.C. Memo. 2003-85; Cohen v. Comm'r, T.C. Memo. 2003-42; Miner v. Comm'r, T.C. Memo. 2003-39; Woodall v. Comm'r, T.C. Memo. 2002-318; Kinslow v. Comm'r, T.C. Memo. 2002-313; Hastings v. Comm'r, T.C. Memo. 2002-310; Mantakounis v. Comm'r, T.C. Memo. 2002-306; Witcher v. Comm'r, T.C. Memo. 2002-292; Nunn v. Comm'r, T.C. Memo. 2002-250; Johnson v. Comm'r, T.C. Memo. 2002-239; Kuberski v. Comm'r, T.C. Memo. 2002-200; Burnett v. Comm'r, T.C. Memo. 2002-181 aff'd 91 A.F.T.R.2d (RIA) 2376 (5th Cir. 2003); Middleton v. Comm'r, T.C. Memo. 2002-164; Sawukaytis v. Comm'r, T.C. Memo. 2002-156; Flores v. Comm'r, T.C. Summ. Op. 2003-56; Kilson v. Comm'r, T.C. Summ. Op. 2003-44; Hartz v. Comm'r, T.C. Summ. Op. 2003-25; Turner v. Comm'r, T.C. Summ. Op. 2003-6; Heidrick v. Comm'r, T.C. Summ. Op. 2002-115; Hess v. Comm'r, T.C. Summ. Op. 2002-90; and Russo v. Comm'r, T.C. Summ. Op. 2002-88.

[9] Guarna v. Comm'r, T.C. Summ. Op. 2003-65.

[10] JHK Enters. Inc. v. Comm'r, T.C. Memo. 2003-79 and Smith v. Comm'r, T.C. Summ. Op. 2003-38.

[11] Aston v. Comm'r, T.C. Memo. 2003-104; Meyer v. Comm'r, T.C. Memo. 2003-12; and O'Toole v. Comm'r, T.C. Memo. 2002-265.

The failure to file penalty was the primary issue, after concessions and/or stipulations, in only two of the cases analyzed.[12] The failure to file penalty was not the primary issue in the other 29 cases but was considered in conjunction with other tax deficiencies. In all but one case, the IRS prevailed in asserting the penalty. The court determined in this one case that the taxpayer had reasonable cause for his failure to file individual returns on time.[13]

Twenty-six, or 84 percent, of the cases were litigated without the benefit of counsel (*pro se*), although the taxpayers named in three of these cases were attorneys themselves.[14] The one taxpayer who prevailed in asserting reasonable cause represented himself before the court.[15] Otherwise, there was no difference in the outcome of the cases for this issue when counsel represented the taxpayer.

The court specifically considered reasonable cause in 29 cases; there was no mention of reasonable cause in the other two. In 15 cases, the taxpayer "failed to offer evidence of" or establish reasonable cause. In the remaining cases, taxpayer statements of reasonable cause included:

- "unusual" personal circumstances and excessive work;[16]
- loss of close relatives (but not stated when);[17]
- being overwhelmed by divorce, custody battle, and job;[18]
- reliance on accountant who helped prepare the return;[19]
- procrastination and misunderstanding of the tax law when a refund was anticipated;[20]
- name was misspelled on income documents;[21] and
- not having access to tax records due to a temporary living situation.[22]

The court rejected each of these explanations. The only instance in which the court accepted reasonable cause was where the taxpayer had been diagnosed with a terminal

[12] Kilson v. Comm'r, T.C. Summ. Op. 2003-44 and Russo v. Comm'r, T.C. Summ. Op. 2002-88.

[13] Meyer v. Comm'r, T.C. Memo. 2003-12.

[14] Woodall v. Comm'r, T.C. Memo. 2002-318; Hastings v. Comm'r, T.C. Memo. 2002-310; and Johnson v. Comm'r, T.C Memo. 2002-239.

[15] Meyer v. Comm'r, T.C. Memo. 2003-12.

[16] Johnson v. Comm'r, T.C. Memo. 2002-239.

[17] Cohen v. Comm'r, T.C. Memo. 2003-42.

[18] Maher v. Comm'r, T.C. Memo. 2003-85.

[19] Middleton v. Comm'r, T.C. Memo. 2002-164.

[20] Nunn v. Comm'r, T. C. Memo. 2002-250.

[21] O'Toole v. Comm'r, T.C. Memo. 2002-265.

[22] Witcher v. Comm'r, T.C. Memo. 2002-292.

illness, had suffered a nervous breakdown, and had taken a leave of absence from his job.[23]

A common finding was that although taxpayers may have experienced traumas in their lives, if they were able to continue to "carry on business" they did not meet reasonable cause for a failure to file their returns. Reliance on a tax preparer was not sufficient to prove reasonable cause if the taxpayers did not show that they took adequate steps to determine the preparer's qualifications, and gave the preparer complete information about their income and deductions.[24]

In eight of the 31 litigated cases, the taxpayers promoted positions that the Tax Court found to be frivolous and groundless.[25] As a result, the court imposed an additional penalty under the provisions of Internal Revenue Code section 6673 in seven cases.[26] In the remaining case, the court warned the taxpayer that the frivolous position penalty could be imposed if he persisted in using the arguments.[27] One other taxpayer was subjected to the IRC § 6673 penalty because the court found that she did not have good faith grounds for her position that she did not receive the wages, non-employee compensation, and distributions from individual retirement accounts in question.[28] In each case where the IRC § 6673 penalty was imposed, the taxpayers represented themselves before the court. The following table details the Tax Court's application of penalties under IRC § 6673 for the cases litigated for the failure to file penalty.

[23] Meyer v. Comm'r, T.C. Memo. 2003-12.

[24] Middleton v. Comm'r, T.C. Memo. 2002-164.

[25] "Frivolous" is defined as lacking a legal basis or legal merit; not serious; not reasonably purposeful. *Black's Law Dictionary 535* (Abridged 7th ed. 2000). "Groundless" is defined as lacking reason or validity. *Black's Law Dictionary* 564 (Abridged 7th ed. 2000).

[26] IRC § 6673(a)(1) allows the Court to sanction a taxpayer when it appears to the Tax Court that proceedings have been instituted or maintained by the taxpayer primarily for delay, the taxpayer's position is frivolous or groundless, or the taxpayer unreasonably failed to pursue available administrative remedies. The Tax Court, in its decision, may require the taxpayer to pay the U.S. a penalty not in excess of $25,000.

[27] Burnett v. Comm'r, T.C. Memo. 2002-181, aff'd 91 A.F.T.R.2d (RIA) 2376 (5th Cir. 2003).

[28] Spurlock v. Comm'r, T.C. Memo. 2003-124.

TABLE 3.6.1, IRC § 6673 SANCTIONS IMPOSED

CASE	CITATION	§6673(a)(1) PENALTY AMOUNT
Aston v. Commissioner	T.C. Memo. 2003-104	$2,500
Burnett v. Commissioner	T.C. Memo. 2002-181, aff'd 91 A.F.T.R. 2d (RIA) 2376 (5th Cir. 2003)	Warning
Cabirac v. Commissioner	120 T.C. 163 (2003)	$2,000
Hill v. Commissioner	T.C. Memo. 2003-144	$15,000
Hilvety v. Commissioner	T.C. Memo. 2003-119	$500
Kinslow v. Commissioner	T.C. Memo. 2003-313	$1,000
Nunn v. Commissioner	T.C. Memo. 2002-250	$7,500
Sawukaytis v. Commissioner	T.C. Memo. 2002-156	$12,500
Spurlock v. Commissioner	T.C. Memo. 2003-124	$1,000

CONCLUSION

The analysis of cases litigated for issues including the failure to file penalty does not lend itself to proposals for legislative or administrative change. The penalty was the primary issue in dispute in just two of the litigated cases analyzed. Nearly half, or 45 percent, of the taxpayers for whom the penalty was an issue in their litigation failed to file returns, fully report their income, and/or cooperate with the IRS in resolving the deficiency question. Public knowledge of the due date for individual tax returns is common and the filing deadline is routinely publicized by the IRS and in the media each year. There were no disputes of the penalty calculation, which is generally a computer-based computation generated by comparing the required due date of a return with its received date and which is automatically recalculated if the tax upon which it is based is changed. Frontline IRS employees are authorized to abate the failure to file penalty within certain limitations based on determinations of reasonable cause.[29] Taxpayers are also entitled to appeal penalty abatement decisions.

The National Taxpayer Advocate, however, continues to support two legislative change proposals that involve the failure to file penalty. In her 2001 Annual Report to Congress, the National Taxpayer Advocate proposed a one-time abatement of the failure to file penalty for first time filers and taxpayers with a consistent history of compliance.[30] This would broaden the definition of reasonable cause and give the IRS the authority to abate a late filing penalty for inadvertent taxpayer mistakes.

[29] Internal Revenue Manual 21.1.3.

[30] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), p.188.

In its 1999 Report to Congress on Penalty and Interest Provisions of the Internal Revenue Code, the Department of Treasury proposed to modify the rate structure for the failure to file penalty.[31] The recommendation was to restructure the penalty to 0.5 percent per month for the first six months, and then to one percent per month for any remaining amount due until the maximum penalty of 25 percent was reached. This would alleviate imposition of a severe penalty in the first few months of delinquency and encourage taxpayers to resolve their filing delinquency earlier. The National Taxpayer Advocate supported the recommendation in her previous position as director of a Low Income Taxpayer Clinic.[32] The recommendation also received the backing of the American Bar Association Section of Taxation.[33] Both of these proposals still merit consideration.

[31] U.S. Department of Treasury, *Report to Congress on Penalty and Interest Provisions of the Internal Revenue Code* (1999) p. 59.

[32] Penalty and Interest Provisions in the Internal Revenue Code: Hearing Before the Senate Finance Committee, 106th Cong., 2nd Sess., March 9, 2000 (Statement of Nina E. Olson, Executive Director of The Community Tax Law Project), available at http://www.finance.senate.gov/3-9olso.htm.

[33] Hearing Before the Subcommittee on Oversight, House Ways and Means Committee, 106th Cong., 1st Sess., November 9, 1999 (Statement of Pamela F. Olson, Chair-Elect of the Section of Taxation, American Bar Association), available at http://www.abanet.org/tax/pubpolicy/1999.

LITIGATED
ISSUE #7

MOST LITIGATED ISSUE: ITEMIZED CHARITABLE CONTRIBUTIONS

SUMMARY

Twenty-one cases involving itemized charitable contributions were litigated in the U.S. Tax Court between June 1, 2002 and May 31, 2003. The majority of the cases are specifically related to a project worked by the IRS regarding one income tax return preparer.

The Court ruled in favor of the IRS in 62 percent of these cases, often finding that taxpayers failed to substantiate their deductions or demonstrate ordinary business care and prudence in their record keeping.

In the Preparer Project cases, the Court found deductions were fabricated by means of a formula calculation allowing the amounts deducted to appear reasonable and therefore without question. The preparer had advised the taxpayers that such deductions needed no substantiation and were not questioned by the IRS.

Circumstances found in this particular project demonstrate a need for the IRS to maintain a compliance presence in this area of tax law because it is easy to inflate (and even invent) charitable contribution deductions.

PRESENT LAW

The computation of taxable income under Internal Revenue Code section 63 is an important and necessary step for calculating the individual federal income tax due.[1] Taxpayers may subtract either a standard deduction or an aggregate itemized deduction amount from gross income to arrive at their taxable income. The standard deduction amount depends on the taxpayer's filing status.[2] An additional standard deduction is available to taxpayers who are age 65 or older, blind, or both.[3]

Itemized deductions are specified deductions described in IRC §§ 161 through 198, and IRC §§ 211 through 222, including gifts to charity.[4] A gift to charity is a contribution where there is no expectation of goods or services equal to the value of the contribution.[5] The law allows a deduction for charitable contributions made during the year if the contributions are substantiated.[6] The Internal Revenue Code describes the types of organizations that are eligible to receive deductible charitable contributions. The IRS annually publishes a list of these organizations.[7]

[1] IRC § 63.

[2] IRC § 63 (c)(2). Standard deduction amounts are adjusted annually for inflation using the Consumer Price Index per IRC § 63(c)(4).

[3] IRC § 63(c)(3).

[4] IRC §170.

[5] Hernandez v. Comm'r, 490 U.S. 680 (1989).

[6] IRC §170(a); See also Treas. Reg. § 1.170A -13.

[7] IRS Publication 78 Cumulative List of Organizations described in IRC § 170(c).

Internal Revenue Code section 170 imposes requirements for the type of documentation needed to substantiate a charitable contribution deduction depending on the dollar value and the type of property involved. A taxpayer may not deduct any contribution of $250 or more unless it is substantiated by a contemporaneous written acknowledgement from a qualifying organization.[8]

In general, the amount of a charitable contribution in property other than money is the fair market value of the property at the time of the contribution. Internal Revenue Code section 170(b) limits the amount of contributions that taxpayers may claim. Internal Revenue Code section 170(e) provides additional limitations on contributions of appreciated property. The applicable limitations depend upon the type or nature of the property contributed, the recipient of the property, and whether the contributed property can be used by the charitable organization for its exempt purpose. Contributions of property other than money that exceed $500 in value require additional record keeping and filing.[9]

ANALYSIS OF LITIGATED CASES

In tax year 2001, nearly 45 million (34 percent) of taxpayers itemized their deductions;[10] of those, over 39 million (88 percent)[11] claimed a charitable contribution deduction, with the average deduction that year nearly $3,500.[12]

Twenty-one cases involving charitable contributions were litigated in the federal courts between June 1, 2002, and May 31, 2003. A detailed listing of the cases is found in Table 7 in Appendix 2. The table categorizes the cases by taxpayer name, court of venue, whether the case was litigated without the benefit of counsel to the taxpayer (*pro se*), and the decision of the court. In general litigation centered on the dual requirements of proper substantiation and valuation of the charitable contribution deduction.

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[8] IRC § 170(f).

[9] Treas. Reg. §§ 1.170A-1(c) and 1.170-13(b)(3).

[10] IRS Statistics of Income Division Table, Tax Year 2001, *United States Selected Income and Tax Items for Individual Income Tax Returns*; Internal Revenue Service, Information Services, Martinsburg Computing Center, Master File Service Support Branch, unpublished data, April, 2003; Line 69 amount 44,961,551 divided by Line 10 amount of total filed returns 130,977,215 = 34 percent.

[11] IRS Statistics of Income Division Table, Tax Year 2001; *United States Selected Income and Tax Items for Individual Income Tax Returns*; Internal Revenue Service, Information Services, Martinsburg Computing Center, Master File Service Support Branch, unpublished data, April, 2003; Line 147.

[12] IRS Statistics of Income Division Table, Tax Year 2001, *United States Selected Income and Tax Items for Individual Income Tax Returns*; Internal Revenue Service, Information Services, Martinsburg Computing Center, Master File Service Support Branch, unpublished data, April 2003; Line 148 amount $137,754,032,000 divided by Line 147 amount 39,430,565 = $3,500.

All 21 cases were litigated in the United States Tax Court. The Court ruled in favor of the IRS on the charitable contribution issue in thirteen of the cases tried (62 percent), rendered split decisions in seven other cases (33 percent), and ruled in favor of the taxpayer in one case (five percent). In the split decisions, the taxpayers were allowed limited deductions based on the Court's use of its discretionary authority to estimate the amount of allowable contributions.[13]

In eighteen of the cases (86 percent) the taxpayers represented themselves before the Court, *pro se*. Seventeen of the cases were decided at least in part for the IRS. The taxpayer prevailed in one case.[14]

Thirteen of the twenty-one cases litigated (62 percent) involved a tax return preparer project conducted by the Compliance function of the IRS in the southwestern United States.[15] The common factors in all 21 cases were the Court's finding that taxpayers failed to substantiate the value of the contributions and/or that the contributions were actually made. In one case, the Court found that taxpayers failed to obtain verifiable independent appraisals of the valuation of property contributed in support of the valuation claimed as a deduction.[16]

In some cases, taxpayers claimed charitable contribution deductions to ineligible recipients. One taxpayer deducted donations to individuals not qualifying as charitable recipients.[17] In yet another case, taxpayers deducted gifts to family members for birthdays, weddings and holidays.[18] One taxpayer deducted donations made for his own benefit in the capacity of a minister of the clergy.[19]

In the Preparer Project cases, the Court found instances where charitable donations were invented and claimed on the returns as deductions without any substantiation. The deduction amounts were "calculated" by means of a formula to appear reasonable given the income levels on the returns. The preparer had informed the taxpayers that they did not need substantiating records supporting the deductions.[20]

[13] Wiley v. Comm'r, T.C. Summ. Op. 2002-116; Chambers v. Comm'r, T.C. Summ. Op. 2002-105; Satriana v. Comm'r, T.C. Summ. Op. 2002-84; Pacheco v. Comm'r, T.C. Summ. Op. 2002-82; Lavigne v. Comm'r, T.C. Summ. Op. 2002-81; Cisneros v. Comm'r, T.C. Summ. Op. 2002-73; Parrett v. Comm'r, T.C. Summ. Op. 2002-72.

[14] Cisneros v. Comm'r, T.C. Summ. Op. 2002-73.

[15] IRS Compliance project in New Mexico consisting of between 200 and 300 returns.

[16] Satriana v. Comm'r, T.C. Summ. Op. 2002-84.

[17] Blankson v. Comm'r, T.C. Summ. Op. 2003-12.

[18] Brown v. Comm'r, T.C. Summ. Op. 2002-91.

[19] Smith v. Comm'r, T.C. Summ. Op. 2003-16.

[20] Wiley v. Comm'r, T.C. Summ. Op. 2002-116; Chambers v. Comm'r, T.C. Summ. Op. 2002-105; Brown v. Comm'r, T.C. Summ. Op. 2002-91; Satriana v. Comm'r, T.C. Summ. Op. 2002-84; Pacheco v. Comm'r, T.C. Summ. Op. 2002-82; Parrett v. Comm'r, T.C. Summ. Op. 2002-72; White v. Comm'r, T.C. Summ. Op. 2002-70.

CONCLUSION

The IRS prevailed, at least in part, in all but one of the 21 cases litigated during the period covered by our analysis.[21] In 16 of these cases the taxpayers failed to provide substantiation for the deductions, and in four cases taxpayers claimed deductions for contributions to ineligible parties.

These litigation results clearly sustain the requirements of the law regarding the verification and qualification of the charitable contributions deductions sought by taxpayers. On the basis of these cases, it is clear that taxpayers must exercise better judgment and care in determining their charitable contribution deductions.

The pattern of actions uncovered in the Preparer Project cases demonstrates a need for the IRS to maintain a compliance presence in this area of tax law. These cases portray how easy it is to inflate (and even invent) charitable contribution deductions.

[21] The exception was Cisneros v. Comm'r, T.C. Summ. Op. 2002-73.

LITIGATED
ISSUE #8

MOST LITIGATED ISSUE: ABUSIVE TRUSTS

SUMMARY

The trust, because it can eliminate income by making distributions to other trusts or other entities, is one of the business forms of choice for taxpayers involved in abusive schemes.[1] Although only 17 abusive trust cases were litigated between June 1, 2002 and May 31, 2003, the use of the trust as a tax shelter still exists. IRS compliance initiatives, especially in the area of abusive schemes, are likely to produce an increase in such cases in the next reporting period.

PRESENT LAW

Definition

A valid trust is a legal arrangement creating a separate legal entity. To create a trust, a grantor (owner of the assets) conveys legal title to property to a trustee. Subchapter J of the Internal Revenue Code, which encompasses sections 641 through 692, governs the taxation of trusts, estates, and their beneficiaries. For purposes of the Internal Revenue Code, the term "trust" is generally defined as " an arrangement created either by a will or by an *inter vivos*[2] declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."[3]

State law defines the requirements for a valid trust, the fiduciary responsibilities of the trustees with respect to trust property and beneficiaries, and the property interests and rights of beneficiaries. Federal law governs the federal taxation of trusts. Recognition as a trust under state law does not guarantee that an entity will be taxed as a trust for purposes of federal income tax.[4]

Federal Income Taxation

Subchapter J, enacted as part of the 1954 Code, governs the taxation of trusts. The trust is considered a conduit (like a partnership) for items to be distributed and taxed to the beneficiaries. Unlike a partnership, however, the trust is not a pure "pass through" entity because the trust can also be subject to an entity level tax.[5] Trust income that is not

[1] IRS, *Basic Trust Taxation* - Abusive Trust Schemes, available at http://www.irs.gov.

[2] Of or relating to property conveyed not by will or in contemplation of an imminent death, but during the conveyor's lifetime, *Black's Law Dictionary*, 826-827 (7th ed. 1999).

[3] Treas. Reg. § 301.7701-4(a). A chancery or probate court is a state court that has the primary jurisdiction over the administration of trusts and estates.

[4] Rev. Rul. 80-75, 1980-1 C.B. 314.

[5] IRC § 641.

distributed to the beneficiaries is taxed to the trust, using a rate schedule that applies only to trusts and estates.[6] A trust must file an annual federal income tax return, Form 1041 US Income Tax Return for Estates and Trusts.[7] The Form 1041 Schedule K-1, Beneficiary's Share of Income, Deductions, Credits, etc. reports the items taxed at the beneficiary's level.[8]

A trust's taxable income is computed and taxed in the same manner as individual income.[9] Unlike individuals, however, trusts are generally entitled to take an unlimited deduction for charitable contributions.[10] Depreciation, depletion and amortization deductions are allocated between the trust and the beneficiaries.[11]

Abusive or Sham Trusts

The Supreme Court has stated that the substance rather than the form of a transaction is controlling for tax purposes.[12] In cases where the courts have ruled that a trust lacks economic substance, these factors are considered in making this determination:

1. Whether the taxpayer's relationship as grantor to property purportedly transferred into trust differed materially before and after the trust formation;
2. Whether the trust had a bona fide independent trustee;
3. Whether an economic interest in the trust passed to trust beneficiaries other than the grantor; and
4. Whether the taxpayer honored restrictions imposed by the trust or by the law of trusts.[13]

In an abusive trust arrangement, income is reassigned from an individual to a trust. If there is no substantial change in the way business and personal matters are handled before and after the formation of a trust, the trust is considered a sham for federal tax purposes.[14] In Publication 2193 (Too Good to be True Trust) The IRS enumerated elements commonly found in abusive trust promotions:

- A promise to reduce or eliminate income and self-employment tax;
- Deductions for personal expenses paid by the trust;

[6] IRC § 1(e); Treas. Reg. § 1,641(a)-1.

[7] Treas. Reg. § 1.6012-3(a).

[8] IRC § 6034A; Treas. Reg § 301.6722-1(d)(2)(i).

[9] Treas. Reg. § 1.641(a)-2.

[10] IRC § 642(c).

[11] IRC § 642(e) and (f).

[12] Gregory v. Helvering, 293 U.S. 465 (1935).

[13] Markosian v. Comm'r, 73 T.C. 1235 (1980); see also Cim Trust v. Comm'r, T.C. Memo. 2001-172.

[14] Snyder v. Comm'r, T.C. Memo. 2001-255.

- Depreciation deductions on an owner's personal residence and furnishings;
- High fees for trust package, to be offset by promised tax benefits;
- Use of backdated documents;
- Unjustified replacement of trustee;
- Lack of an independent trustee;
- Use of post office boxes for trust addresses;
- Use of terms such as pure trust, constitutional trust, sovereign trust.

The sham theory is appropriate where trust funds are used to pay the grantor's personal living expenses, and the grantor exercises dominion and control over trust assets as if they were the grantor's own assets.[15] For example, in *United States v. Novotny*,[16] the court stated that although the taxpayer transferred parcels of property to trusts, he continued to use the property for his own benefit. The court held that the trusts were shams because the taxpayer retained full control over the property.

Abusive trust schemes often hide the true ownership of assets and income or disguise the substance of transactions. They use multiple levels of entities with no apparent business purpose. The same taxpayer may place different assets in different trusts to set up rental or sales agreements, which shift income or create deductions out of personal expenses. In addition, taxpayers are increasingly avoiding tax through foreign trusts, which are often formed in countries that impose little or no tax on trusts and also provide secrecy. Abusive foreign trust arrangements typically enable taxable funds to flow through several trusts or entities until the funds are ultimately distributed or made available to the original owner, purportedly tax-free.

ANALYSIS OF LITIGATED CASES

Seventeen trust cases were litigated in the federal court system between June 1, 2002, and May 31, 2003. The cases can be summarized as follows:

TABLE 3.8.1, ABUSIVE TRUST CASES

ORIGIN OF LITIGATED CASE	NUMBER OF CASES
Injunction	5
Income Tax Examination	8
Criminal Investigation	1
Collection Action	3

[15] Acuff v. Commissioner, 35 T.C. 162 (1960) aff'd 296 F.2d 725 (6th Cir. 1961).

[16] United States v. Novotny, 2002-2 U.S.T.C. (CCH) ¶50,637 (D.C. Colo. 2002).

A more detailed listing of the cases is found in Table 8 in Appendix 2. The government prevailed in all 17 of the litigated cases.

In nine of the litigated cases, taxpayers represented themselves before the court, *pro se* (two of these taxpayers failed to appear before the court). Attorneys represented the taxpayers in the remaining eight cases.

Injunction Cases

The court issued injunctions in five of the cases. An injunction can forbid the taxpayer from organizing, promoting, marketing, and selling trusts or abusive tax shelters.[17] The injunction is an important tool in combating the marketing of tax evasion schemes. The U.S. district courts have the authority to grant injunctive relief.[18] Internal Revenue Code section 7402 describes the jurisdiction of the district courts in various civil actions, while IRC § 7407 authorizes the district court to enjoin income tax preparers, and IRC § 7408 addresses enjoining promoters of abusive tax shelters.

In *United States v. Welti*,[19] the government was seeking to enjoin Mr. Welti from preparing income tax returns that understate the taxpayer's tax liability through the use of trusts. In seeking the injunction, an IRS employee who testified at the trial pointed out that a notice on the topic of abusive trusts has been available to taxpayers since April 1997.[20] In the *Welti* case, the Court noted that the notice addressed the legal principles upon which the trusts at issue in the case would be evaluated.

Those principles taken from Notice 97-24 are:

- Substance - not form - controls taxation;
- Grantors may be treated as owners of trusts;
- A non-grantor trust is taxed on its taxable income reduced by distributions to beneficiaries;
- Transfers to trusts may be subject to estate and gift taxes;
- Personal expenses are generally not deductible;

[17] Internal Revenue Manual 20.1.6.8.

[18] IRC §§ 7402, 7407, and 7408.

[19] United States v. Welti, 90 A.F.T.R.2d (RIA) 7472 (S.D. Ohio 2002).

[20] *See* Notice 97-24, 1997-1 C.B. 409.

- A genuine charity must benefit in order to claim a valid charitable deduction;
- Special rules apply to foreign trusts;
- Civil and/or criminal penalties may apply.[21]

During the trial of the *Welti* case, the IRS pointed out that this notice encouraged taxpayers who had participated in abusive trusts arrangements to voluntarily disclose their participation by filing amended income tax returns.

In another injunction case, *United States v. Prater,*[22] the taxpayer promoted abusive tax schemes based upon what has become known as the IRC § 861 argument. This position relies on two premises which courts have determined to be invalid: 1) that the phrase "gross income from whatever source derived" in IRC § 61 is not clear, so one must look elsewhere in the Internal Revenue Code for clarification; and 2) the place to look for clarification is the foreign-source rules found in IRC §§ 861 through 865, and the corresponding Treasury regulations.[23]

Under this theory, the taxpayers assert that IRC §§ 861 through 865 and the applicable regulations limit taxable "sources" of income to certain foreign-based activities.[24] Notice 2001-40[25] was issued to inform taxpayers that this position has no basis in law, and to advise taxpayers they may be subject to penalties including, but not limited to, the accuracy-related penalty[26] and the frivolous return penalty.[27]

In the *Prater* case the court enjoined the taxpayer from preparing tax returns, marketing his abusive tax schemes and promoting "the false and frivolous position that U.S. source income is nontaxable (the IRC § 861 argument)."[28]

Individuals, through postings on their websites, promoted the IRC § 861 argument. The growing use of this argument has been reported in The New York Times.[29] Former IRS Commissioner Rossotti was questioned about this and other frivolous theories at a Senate hearing on April 5, 2001.[30] During the period covered by this report, the IRS has

[21] United States v. Welti, 90 A.F.T.R. 2d (RIA) 7472 (S.D. Ohio 2002). Also see Notice 97-24, 1997-1 C.B. 409.

[22] United States v. Prater, U.S. Dist. LEXIS 25685 (M.D. Fla.) (2002).

[23] Treas. Reg. §§ 1.861 - 1.865.

[24] Notice 2001-40, 2001-1 C.B. 1355.

[25] Id.

[26] IRC § 6662.

[27] IRC § 6702.

[28] United States v. Prater, U.S. Dist. LEXIS 25685 (M.D. Fla.) (2002).

[29] David Cay Johnston, "Judge Orders Groups to Stop Promoting Income Tax Evasion," The New York Times, January 12, 2003, Section 1, p. 18.

[30] Taxpayer Beware: Schemes, Scams and Cons: Hearing Before the Committee on Finance, United States Senate, 107th Cong., 1st Sess., pg. 36 (2001) (Testimony of Charles Rossotti, Commissioner of Internal Revenue Service).

increased enforcement activities against these promoters through civil and criminal proceedings. On May 7, 2003, IRS Commissioner Everson testified before a House Appropriations Subcommittee on this very topic, citing IRS successes in these areas.[31]

Income Tax Examination Cases

In *George v. Commissioner*,[32] the taxpayer transferred his osteopathic medical practice to a trust, which paid personal expenses such as automobile and residence expenses. According to the court, the taxpayer's purpose for transferring his business to the trust was tax avoidance, and money paid to the trust for the taxpayer's services was taxable income to the taxpayer.

In *Edwards v. Commissioner*,[33] the taxpayer was operating several different businesses using trusts. The taxpayer conceded at trial that the trusts were invalid for federal income tax purposes and the trust income and deductions should be reallocated to him. The taxpayer also deducted the expenses of maintaining his personal residence as business deductions taken against business income. The taxpayer was unable to meet the principal place of business requirement of IRC § 280A[34] or satisfy the gross income limitation of IRC § 280A(c)(5). The Tax Court sustained the disallowance of those deductions on the grounds that they were personal expenses. *Edwards* attempted to explain his lack of compliance by his reliance on the advice of an expert. The Tax Court found this explanation unreasonable and stated that if "something seems too good to be true, it probably is."[35]

Criminal Cases

There was one criminal case litigated during the period under consideration. In *United States v. DeMott*,[36] the defendants appealed their conviction for tax fraud involving the creation of sham trusts and the sale of worthless land patents (land grants).

Collection Action Cases

In United States v. Nipper,[37] the government determined that the taxpayer did not report taxable income from his trash collection business and had unreported rental income. Nipper disputed the validity of the assessments arising from this unreported income. The government met the burden of connecting the taxpayer to a source of the unreported

[31] Departments of Transportation, Treasury, and Independent Agencies, Appropriations for Fiscal Year 2004: Hearing Before the House Appropriations Subcommittee, 108th Cong., 1st Sess., p. 4 (2003) (Testimony of Mark W. Everson, Commissioner, Internal Revenue Service).

[32] George v. Comm'r, T.C. Memo. 2002-163.

[33] Edwards v. Comm'r, T.C. Memo. 2002-169.

[34] IRC § 280A(c).

[35] Edwards v. Comm'r, T.C. Memo. 2002-169.

[36] United States v. DeMott, 91 A.F.T.R. 2d (RIA) 751 (9th Cir. 2003).

[37] United States v. Nipper, 91 A.F.T.R. 2d (RIA) 1846 (N.D. Okla. 2003).

income and the assessments were reduced to judgment. The government asserted that the taxpayer fraudulently transferred some of his real property to a sham trust in order to forestall collection activities. The Court found in favor of the Commissioner, holding that the collection activities could go forward.

Cases Settled Prior To Litigation

Many cases do not reach litigation because they are settled with the IRS' Examination, Appeals, Counsel or Criminal Investigation functions. Settled cases fall into two general categories:

- Cases that are settled in IRS Appeals or the Office of Chief Counsel prior to litigation; and
- Cases that are resolved by the IRS Criminal Investigation Division or the Department of Justice prior to litigation.

Cases Settled In IRS Appeals And The Office Of Chief Counsel

Between June 1, 2002 and May 20, 2003, 193 cases involving abusive trusts were settled in IRS Appeals and Counsel before litigation, with Appeals handling 155 cases and Counsel settling 38 others.[38] The cases involved the following issues:

- Trust income attributable to grantor;
- Trust arrangement is a sham;
- Whether income can be assigned to a trust;
- Trust used to evade tax on a business; and
- Abusive trusts.

Cases Settled By IRS Criminal Investigation And The United States Department Of Justice

When IRS Office of Chief Counsel refers a case to the Department of Justice (DOJ), Justice department the case can be rejected or accepted and referred to the United States Attorney's office, which will review the matter and contact the taxpayer. The taxpayer may then concede the case by entering into a plea agreement or contest the issues. If the taxpayer does not enter into a plea agreement, the case will be scheduled for trial.

For fiscal year 2003, ending 9/30/03, IRS Criminal Investigation reported the following:[39]

[38] Data from CASE (Counsel Automated Systems Environment), SB/SE Counsel Information Management System (May 20, 2003).

[39] Department of Treasury, Summary of Abusive Trust Schemes: Statistical Data, available at http://www.treas.gov/irs/ci.

TABLE 3.8.2, CI CASES FOR FY 2003

Fiscal Year 2003 (12 months ending 09/30/03)	Number of Cases
Criminal Investigations Initiated	79
Prosecution Recommendations	80
Indictments/Information	73
Incarceration Rate	79
Average Months to Serve (w/prison)	45
Average Months to Serve (all Sent)	47

Criminal Investigation (CI) had substantial successes during this period. Working with the Department of Justice Tax Division, CI's lengthy undercover operation led to prosecutions of the principals of Anderson Ark Associates.[40] This organization is alleged to have prepared tax returns claiming large tax deductions for fraudulent net operating losses and consulting expenses. Instead of being spent as claimed, the funds were allegedly wired to Costa Rica so that clients could later withdraw them with a debit card.[41] Of particular note is the role that improved technology played in facilitating these investigations. Instead of distributing paper documents to the various offices involved in investigations, CI now can provide investigators and attorneys with hard drives containing all of the relevant documents.[42] The DOJ finds that this change not only assists in the investigations of the promoters, but helps to coordinate work on investor examinations as well.[43] Additionally, the DOJ finds this change important because prompt enforcement action against investors in these schemes demonstrates the consequences of participation and acts as a deterrent to others.[44]

CONCLUSION

The analysis of litigated abusive trust cases identifies one trend. The number of injunction cases rose from one in the period from June 1, 2001, to May 31, 2002 to five during the period covered for this year's report.[45] The increase is attributable to the growing emphasis by the Small Business Self-Employed (SB/SE), Large & Mid-Size Business (LMSB) and Criminal Investigation (CI) divisions of the IRS on the use of this procedure to curtail abusive scheme promotions. Each of the operating divisions is actively seeking out promoters of abusive schemes to stop the proliferation of promotions to taxpayers.

[40] IRS, *FY 2003 Archive Significant Case Summaries* - Abusive Trust Schemes, available at http://*www.irs.gov.*

[41] Id.

[42] Information provided by Department of Justice, Tax Division, December 2, 2003.

[43] Id.

[44] Id.

[45] For an analysis of abusive trust and schemes cases for the period from June 1, 2001 to May 31, 2002, *see* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 334.

The trust is the preferred business form for many of these promotions. Because the trust is a passthrough entity, it is not as easy to track compliance by trust filers as it is with other tax filers. A more effective compliance strategy includes educating taxpayers upfront about the consequences of participating in an abusive tax shelter scheme, rather than using compliance resources to pursue them after they become participants.

The establishment of SB/SE's Lead Development Center demonstrates a coordinated effort to gather information on promoters and refer the information to IRS field compliance to initiate promoter examinations. These examinations are also coordinated in LMSB by the Office of Tax Shelter Analysis (OTSA). CI has a multi-functional national strategy to combat promoters of abusive trusts, emphasizing the identification of fraudulent offshore promotions and the use of civil and criminal enforcement actions.[46]

The IRS anticipates growth in the number of trust returns filed. The projected number of estate and trust returns (Form 1041) to be filed for calendar year 2003 is 3,778,100, an increase of 1.8 percent from 2002.[47] The increase is expected to average two percent annually for the next six years.[48] Although many trusts are legitimate tax or financial planning vehicles, the use of the trust as a vehicle for abusive schemes remains a serious compliance problem.

In April 2003, Acting IRS Commissioner, Robert Wenzel testified before the Senate Appropriations Committee that the principal strategic focus of the President's fiscal year 2004 IRS budget is strengthening compliance activities, especially in the areas of high-income, high-risk taxpayers and businesses, and abusive tax avoidance schemes and offshore trusts.[49]

Due to the IRS' increasing emphasis on compliance activities in the abusive schemes area, it is anticipated that more cases will be worked through the compliance pipeline (IRS Examination, Appeals). Thus, it is likely that the courts will see an increase in abusive scheme cases in the coming years. One possible source for these cases is the Offshore Voluntary Compliance Initiative (OVCI) promoted by IRS. This initiative targets taxpayers that have "...underreported their United States income tax liability through

[46] Department of Treasury, *Summary of Abusive Trust Schemes: CI's Efforts in Combating Abusive Trusts* available at http://www.treas.gov/irs/ci.

[47] "Projections of Returns To Be Filed in Calendar Years 2002-2009," *IRS Statistics of Income Bulletin* (Winter 2002-2003).

[48] Id.

[49] Departments of Transportation, Treasury, and General Government, and Related Agencies Appropriations for Fiscal Year 2004 Before the Senate Appropriations Committee, 108th Cong. (2003) (Testimony of Robert Wenzel, Acting Commissioner, Internal Revenue Service) available at http://www.gpoacces.gov/chearings/index.html.

financial arrangements that in any manner rely on the use of offshore payment cards (including credit, debit, or charge cards) issued by banks in foreign jurisdictions or offshore financial arrangements."[50]

Many of the abusive trust promotions involve encouraging individuals to set up trusts as vehicles for shifting funds offshore, and then repatriating the funds through credit or debit cards. Procedures for participating in this initiative are contained in Rev. Proc. 2003-11. Taxpayers wishing to make a voluntary disclosure had until April 15, 2003 to send in their written requests. Participation in this initiative only mitigates some penalties, and participating taxpayers may still be subject to an IRS audit. The early data indicates that there was a strong response to the OVCI. IRS announced in May 2003 that more that 1200 people came forward to participate.[51] One aspect of OVCI involves gathering information from the investors about the promoters of particular schemes, thus enabling IRS to detect additional promotion efforts.

Another focus of IRS compliance activities is improved methodology in data mining of Schedule K-1, Beneficiary's Share of Income, Deductions, Credits, etc., information. IRS had suspected taxpayers were omitting Schedule K-1 information from their individual income tax returns. In March 2001, Senate Finance Committee Chairman Charles E. Grassley urged Commissioner Rossotti to make computer matching of Schedule K-1 information with its related Form 1040 a priority.[52] IRS research focused on the practice of using multiple or tiered entities to see if there were patterns of non-compliance present.[53] The use of tiered passthrough entities is important because it complicates basic compliance questions about the type of income earned, whose income it is, and whether the income is reported.

Abusive trust arrangements typically use a tiered structure to hide ownership of assets and income. Trusts can also disguise the substance of transactions. Improved computer matching techniques between Schedule K-1 and Form 1040 will enhance compliance efforts in the area of passthroughs.

In 2002 the National Taxpayer Advocate proposed two key recommendations to Congress for combating the proliferation of abusive trust schemes. One recommendation is that IRS partner with "messengers who possess the social power to effect a change in percep-

[50] Rev. Proc. 2003-11, 2003 C.B. 311.

[51] IRS News Release, "Early Data Show Strong Response to Offshore Initiative; Applicants Owe Millions, Reveal Scores of Promoters," IR-2003-58, May 1, 2003.

[52] Letter from Senator Charles E. Grassley to the Commissioner of Internal Revenue (March 28, 2001) cited by Treasury Inspector General For Tax Administration report, *The Internal Revenue Service Successfully Processed Schedules K-1 for Its Matching Program, However, Tax Form Changes Would Reduce Unnecessary Notices to Taxpayer*, TIGTA Reference # 2002-30-141 (July 2002) p. 1.

[53] "Flow-throughs and Tiering: Using Schedule K-1 Data to Study Tax Compliance," SB/SE Research, June 2003 IRS Research Conference.

tion."[54] It is possible that the success of OVCI is particularly attributable to publicity that this initiative received from several key groups: tax practitioners (a traditional source for tax information), state governments, and the Senate Finance Committee.[55]

On June 30, 2003, the National Taxpayer Advocate issued a report detailing the Taxpayer Advocate Service's objectives for fiscal year 2004. Contained in this report is an article that lists a number of research initiatives that TAS is sponsoring or participating in. One of these initiatives is *Abusive Tax Schemes: The "Tipping Point" Study*.[56] The National Taxpayer Advocate is sponsoring this research that is being conducted by the Office of Program Evaluation and Risk Analysis (OPERA) to identify what IRS is doing to detect and combat emerging abusive tax schemes, such as abusive tax shelters, and the slavery reparations scheme. The research study is divided into two phases.

The objective of Phase I, which has been completed, was to identify the approaches, processes, and procedures the IRS has developed and/or implemented that:

- enable early identification of abusive tax avoidance schemes, and
- enable the IRS to mitigate the impact of these schemes before they proliferate.

A comprehensive inventory of these processes and approaches has been compiled. Building upon the taxonomy of schemes developed in Phase I, the National Taxpayer Advocate envisions that the second phase of the study will track the course of "infection" of certain schemes among the taxpayer public. The study will identify who were the key "agents" of the scheme, what paths and fora provided the most fruitful dissemination, and what particular aspect of the scheme appealed to the population so that they were persuaded to participate. This analysis should help the IRS to identify when, how, and with whom it should intervene in order to prevent the proliferation of certain types of abusive schemes.

[54] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 341.

[55] IRS News Release, "Early Data Show Strong Response to Offshore Initiative; Applicants Owe Millions, Reveal Scores of Promoters," IR-2003-58 (May 1, 2003).

[56] National Taxpayer Advocate, *Report to Congress: Fiscal Year 2004 Objectives*, Publication 4054 (Rev. 06-2003), p. 19.

LITIGATED ISSUE #9 MOST LITIGATED ISSUE: ACTIVITY NOT ENGAGED IN FOR PROFIT

SUMMARY

The Office of the Taxpayer Advocate reviewed and analyzed 14 tax cases litigated in the federal courts between June 1, 2002, and May 31, 2003, involving activities not engaged in for profit, or what are commonly referred to as "hobby loss" activities. The majority of the cases were decided in the IRS' favor with the taxpayer prevailing in only two cases. Eight of the 14 taxpayers represented themselves in court, *pro se*, with only one prevailing.

Internal Revenue Code section 183 disallows losses for activities not engaged in for profit. Treasury Regulation § 1.183-2(b) provides a non-exclusive, multifactor test to help determine if an activity is engaged in with a profit motive. This test includes nine objective factors used to evaluate the activity before making a subjective analysis and decision. A review of this year's cases indicates that a broad range of activities is litigated, and the courts do not consistently apply the multifactor test. Both the complexity of the law and the subjective nature of the determination contribute to the number of cases that are eventually litigated. Our review found no specific trends that could be changed legislatively or administratively.

PRESENT LAW

Officially entitled "Activities not engaged in for profit" and enacted as part of the Tax Reform Act of 1969, Internal Revenue Code section 183 is commonly known as the hobby loss provision. Before its enactment, trade or business losses[1] offset other income but were limited to $50,000 per year.[2] This limitation only applied when losses from the activities exceeded $50,000 per year for five consecutive years. In determining the amount of loss under this provision, certain deductions including taxes, interest, casualty losses of the activity, and net operating losses were not considered.

Congress enacted IRC § 183 because the prior hobby loss provision was very limited in its application.[3] The previous law allowed taxpayers to manipulate losses from one year to another, breaking the string of consecutive losses and avoiding application of IRC § 270. Congress also expressed concern that if the provision did apply, the taxpayer faced the combined additional taxes of a five-year period in one year.[4]

[1] IRC § 270 was known as the "hobby loss" provision and limited losses by trade or businesses prior to January 1, 1970. However, it only applied to trade or business expenses, and the courts had repeatedly defined a trade or business as a profit motivated activity. Adam D. Chinn, *Attacking Tax Shelters: Section 183 Leaves The Farm And Goes To The Movies*, 61 N.Y.U. L. Rev. 89 (1986).

[2] Tax Reform Act of 1969, Pub. L. No. 91-172, § 213(b), 83 Stat. 487, 572 (1969)(repealed IRC § 270).

[3] Tax Reform Act of 1969, S. Rep. No. 91-522 at 489 (1969); H.R. Rep. No. 91-413 at 244-245 (1969).

[4] Id.

Internal Revenue Code section 183 disallows deductions to individuals or S corporations for losses incurred in activities not engaged in for profit.[5] Internal Revenue Code section 162 allows deductions for ordinary and necessary expenses paid or incurred in carrying on any trade or business, and IRC § 212 allows deductions for the management, conservation, or maintenance of property held for the production of income. Therefore, if a taxpayer

- is not engaged in a trade or business;
- is not engaged in an activity for the production or collection of income, or
- is not engaged in managing, conserving, or maintaining property that can produce income,

then he or she is considered to be conducting an activity not engaged in for profit.

To understand what constitutes an activity not engaged in for a profit, one must first understand what is considered a trade or business for federal income tax purposes. Despite the importance of the term "trade or business," it is not specifically defined by the Internal Revenue Code or Treasury Regulations, but rather comes from what is called "common law of federal income tax," derived from findings and concepts developed by court decisions.[6] In distinguishing between trade or businesses and activities not engaged in for profit, the Supreme Court stated that

> For income tax purposes Congress has seen fit to regard an individual as having two personalities: "one is [as] a seeker after profit who can deduct the expenses incurred in that search; the other is [as] a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures."[7]

In *Commissioner v. Groetzinger*,[8] the Supreme Court elaborated

> ...that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for the income and profit. A sporadic activity, hobby, or an amusement diversion does not qualify."

[5] IRC 183(a); Treas. Reg. 1.183-1(a). IRC § 1361 defines an S corporation as a small business corporation that has elected to become an S corporation under IRC § 1362(a). The corporation cannot have more than 75 shareholders, cannot have a nonresident alien as a shareholder, cannot have more than one class of stock, and cannot have as a shareholder a person who is not an individual other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6). This provision also applies to trusts and estates since the taxable income of both is computed in the same manner as individuals per IRC § 641(b). The provisions of this section do not apply to the activities of C corporations.

[6] Carol Duane Olson, *Toward a Neutral Definition of "Trade or Business" In the Internal Revenue Code*, 54 U. Cin. L. Rev. 1199 (1986).

[7] United States v. Gilmore, 372 U.S. 39 (1963).

[8] Comm'r v. Groetzinger, 480 U.S. 23, 37 (1987).

In most instances, the facts and circumstances of each case determine the question of whether a taxpayer is engaged in a trade or business.[9] If the gross income produced by the activity exceeds deductions or makes a profit in at least three of five consecutive taxable years, there is a presumption that the activity is engaged in for profit.[10] An activity involving breeding, training, showing, or racing horses is presumed to be not a hobby if it shows a profit in at least two of seven consecutive taxable years.[11]

Initially, the taxpayer bears the burden of proof in establishing a profit motive. However, if the taxpayer meets the legal presumption by earning a profit in the required number of years, the burden of proof shifts to the IRS. Treasury Regulations allow a taxpayer to elect to postpone the determination or presumption until after the close of the fourth year of the activity.[12] The taxpayer makes this election by filing Form 5212, Election To Postpone Determination. The form must be filed within three years after the due date of the return in which the taxpayer first carried on the activity, or if earlier, within 60 days after receiving written notice from the IRS proposing to disallow the activity's deduction.[13]

If an activity is deemed to be not engaged in for profit, some deductions may still be allowed as miscellaneous itemized deductions that are subject to the two percent of adjusted gross income limitation.[14] Treasury Regulations provide that expenses should not exceed gross receipts for an activity not engaged in for profit, and should be deducted in the following order:

- Amounts deductible under the Internal Revenue Code without regard to whether the activity giving rise to the expense is an activity engaged in for profit, for example, mortgage interest, taxes, and casualty losses. These amounts are allowable to the full extent permitted under the code. For example, interest expenses are allowed and limited by the rules contained in IRC § 163(d).[15]

[9] Higgins v. Comm'r, 312 U.S. 212 (1941).

[10] IRC § 183(d). In 1986, IRC § 183 was amended and the presumption rule changed from "two out of five consecutive years" to "three out of five consecutive years." Tax Reform Act of 1986, Pub. L. No. 99-514, § 143(a), 100 Stat. 2085, 2120 (1986).

[11] IRC § 183(d).

[12] Temp. Treas. Reg. § 12.9(a).

[13] Temp. Treas. Reg. § 12.9(c). The postponement lasts until the close of the sixth year for horse breeding, training, showing, or racing. Temp. Treas. Reg. § 12.9(a).

[14] Deductions that are allowable through other code sections such as mortgage interest, real estate taxes, and casualty losses would be allowed in full according to their corresponding IRC sections.

[15] Treas. Reg. § 1.183-1(b)(1)(i).

- Current expenses that do not result in a basis adjustment and would otherwise be allowed if the activity was engaged in for profit.[16] Examples of current expenses include supplies and utilities.
- Amounts that result in a basis adjustment and would otherwise be allowed if the activity was engaged in for profit.[17] Examples of these amounts include depreciation and amortization expenses.

Treasury Regulations identify nine factors that should normally be considered before determining whether or not an activity is engaged in for profit.[18] This non-exclusive list of factors includes:

1) The manner in which the taxpayer carries on the activity;
2) The expertise of the taxpayer or his or her 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 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 earned, if any;
8) The financial status of the taxpayer; and
9) The elements of personal pleasure or recreation associated with the activity.

The IRS and the courts use these nine factors to try to determine whether the taxpayer engaged in the activity with a profit motive. This determination is made by examining the facts and circumstances as they existed when the taxpayer decided to enter the business, not by counting the factors that support each party's position.[19] The nine factors are used to determine whether the taxpayer has an honest objective of making a profit, not whether there is a reasonable expectation of making a profit.[20] Because the provision seeks to determine the taxpayer's intent, the actual business results may be irrelevant. In fact, a taxpayer can have many years of losses in the activity; but if it is determined the intent was to make a profit, the losses would not be disallowed under IRC § 183.[21]

[16] Treas. Reg. § 1.183-1(b)(1)(ii).

[17] Treas. Reg. § 1.183-1(b)(1)(iii).

[18] Treas. Reg. § 1.183-(2)(b)(1) through (9).

[19] Dunn v. Comm'r, 70 T.C. 715, 720 (1978), aff'd., 615 F.2d 578 (2d Cir. 1980).

[20] Taube v. Comm'r, 88 T.C. 464, 478 (1987); Dreicer v. Comm'r, 78 T.C. 642, 645 (1982) aff'd. without opinion 702 F. 2d 1205 (D.C. Cir. 1983).

[21] Schwartz v. Comm'r, T.C. Memo. 2003-86. The taxpayers began their yachting activity in 1991 and had operated it for seven years, including the fours years litigated (1994 through 1997). The taxpayer's incurred losses totaling $180,048 in the four years litigated, and there was no mention of any prior year profits in the Court's discussion of the activity's history of income or losses.

ANALYSIS OF LITIGATED CASES

Fourteen cases involving activities not engaged in for profit were litigated in the federal court system between June 1, 2002, and May 31, 2003. This issue also appeared in the 1998 and 1999 National Taxpayer Advocate's Annual Reports to Congress as a most litigated issue.[22] A detailed listing of this year's cases can be found in Table 9 in Appendix 2. The types of schedules and returns litigated this year on this issue are listed below.

TABLE 3.9.1, HOBBY LOSS CASES

TYPE OF SCHEDULE OR TAX RETURN	NUMBER OF CASES REVIEWED
Form 1040, Schedule C, Profit or Loss from Business (Sole Proprietorship).	10
Form 1120S, U.S. Income Tax Return for an S Corporation.	3
Form 1040, Schedule F, Profit or Loss from Farming.	1

Out of the 12 U. S. Tax Court cases, six taxpayers elected to have their cases conducted under the Court's simplified small tax case procedure.[23] The results of these cases are the non-published Tax Court Summary Opinions that cannot be appealed or cited as precedent for any other case. Of the remaining six Tax Court cases, two did not qualify for the small tax case procedure and four did not make the election.

Twelve of the 14 cases tried resulted in a decision by the court for IRS. Attorneys represented five out of the 12 taxpayers in court, while the remaining seven taxpayers represented themselves without benefit of counsel, or *"pro se."*[24] Of the two cases in which the court decided for the taxpayer, one was *pro se* and one had legal representation.

The activities litigated during this period included:

- tree farming,[25]
- lodge or rental property,[26]

[22] The 1998 National Taxpayer Advocate's Annual Report to Congress divides the most litigated issues between individuals and the self-employed with "activity not engaged in for profit" ranking fourth under self-employed. The 1999 National Taxpayer Advocate's Annual Report to Congress separates the most litigated issues between individuals, small business/self-employed, corporate, and other with "hobby losses" appearing in the small business/self-employed category.

[23] Per IRC § 7463, taxpayers may elect to have cases heard under simple, informal proceedings if the deficiency for any one year, including additions to tax and penalties, is $50,000 or less. The ruling by the Court is final and cannot be reviewed by any other court.

[24] Two of the "*pro se*" taxpayers were practicing attorneys, although neither was mentioned as a tax attorney.

[25] Zarins v. Comm'r, 89 A.F.T.R.2d 3041 (6th Cir. 2002).

[26] Baldwin v. Comm'r, T.C. Memo. 2002-162.

- aircraft transportation,[27]
- horse breeding / racing / training / sales (3 cases),[28]
- gold mining,[29]
- performing arts management,[30]
- automobile racing,[31]
- bowling,[32]
- bed and breakfast,[33]
- yacht racing,[34]
- used automobile sales,[35]
- multi-level marketing (Amway),[36] and
- miscellaneous sales and marketing activities.[37]

While the list includes activities generally considered hobbies, such as horse breeding and yacht racing, it also includes some activities not normally considered recreational. For instance, most people do not associate activities such as tree farming, selling used automobiles, or selling Amway products with a "hobby" and might find it unusual that the IRS classified the business as an activity not engaged in for profit. However, the two cases where the courts ruled for the taxpayer and determined the activities were engaged in for profit were both activities normally considered recreational in nature: bowling and yacht racing.

The courts have found other underlying reasons for participating in activities that result in a loss. In *Lopez v. Commissioner*,[38] the Amway activity was determined not to be engaged in for profit. The court noted, "It also appears that a substantial portion of the

[27] Baldwin v. Comm'r, T.C. Memo. 2002-162.

[28] Kuberski v. Comm'r, T.C. Memo. 2002-200; Hastings v. Comm'r T.C. Memo. 2002-310; Prieto v. Comm'r, 91 A.F.T.R.2d (RIA) 1423 (9th Cir. 2003).

[29] Heidrick v. Comm'r, T.C. Summ. Op. 2002-115.

[30] Carino v. Comm'r, T.C. Summ. Op. 2002-140.

[31] Turner v. Comm'r, T.C. Summ. Op. 2003-6.

[32] Whitehurst v. Comm'r, T.C. Summ. Op. 2003-7.

[33] Hogan v. Comm'r, T.C. Summ. Op. 2003-8.

[34] Schwartz v. Comm'r, T.C. Memo. 2003-86.

[35] Mayo v. Comm'r, T.C. Summ. Op. 2003-51.

[36] Lopez v. Comm'r, T.C. Memo. 2003-142.

[37] Montgomery v. Comm'r, T.C. Memo. 2003-64. The taxpayer's testimony states his S corporation was involved in real estate, sales of pre-paid calling cards, gold coins, "a vitamin-type product", and a "program for debt freedom."

[38] Lopez v. Comm'r, T.C. Memo. 2003-142.

time petitioners spent on their Amway activity involved socializing with family and friends."[39] In *Hogan v. Commissioner*,[40] the court agreed with the IRS that the taxpayer did not engage in his bed and breakfast activity for profit, but as a means of sheltering his W-2 income.

The courts use IRC § 183 both to differentiate between business and hobby activities and to disallow losses sheltering other income and financing personal activities. For example, in Hogan, the taxpayer deducted so many personal expenses as business expenses that it prompted the court to observe that: "Petitioner's use of various schedules on his returns shows that he learned to use them as a tax cash cow.[41]" In 1996 and 1997, the years litigated, the taxpayer also deducted losses for beef cattle farming yet owned no cattle. In addition, he deducted a loss in 1997 from what the court described as his "alleged" wood working activity.

Use of relative factors in Treasury Regulation 1.183-2(b)

In determining whether an activity is engaged in for profit, the courts consider all the relevant facts and circumstances of the case and not just a taxpayer's statement of his or her motive to make a profit.[42] The nine factors listed in Treas. Reg. § 1.183-2(b) are used to analyze the facts and circumstances; however, the factors are not appropriate or applicable in every case.[43] While no single factor is controlling, some factors may carry more weight in making the determination.

The courts rely upon one factor more often and apparently give it considerable weight in profit motive determinations. The factor involves the manner in which the taxpayer carries on the activity, particularly how the taxpayer used books and records. The courts have held that books and records should not just be kept for substantiation, but to assist the taxpayer in making informed business decisions as a means of increasing the profits of the venture.[44] In both cases where the taxpayer prevailed, the courts cited the taxpayer's change in techniques and methods based on the records they kept as a factor in determining the activities were engaged in for profit.[45] The Courts specifically cited this as a factor in seven cases where the IRS prevailed. In one case, even when the taxpayers maintained extensive and detailed records, the court, in deciding for the government's position, cited this key factor stating: "Although petitioners maintained detailed records

[39] Lopez v. Comm'r, T.C. Memo. 2003-142.

[40] Hogan v. Comm'r, T.C. Summ. Op. 2003-8.

[41] Id.

[42] Dreicer v. Comm'r, 78 T.C. 642 (1982).

[43] Abramson v. Comm'r, 86 T.C. 360 (1986).

[44] Lopez v. Comm'r, T.C. Memo. 2003-142; Kuberski v. Comm'r, T.C. Memo. 2002-200; Baldwin v. Comm'r, T.C. Memo. 2002-162; Hogan v. Comm'r, T.C. Summary Opinion 2003-8.

[45] Schwartz v. Comm'r, T.C. Memo. 2003-86; Whitehurst v. Comm'r, T.C. Summary Opinion 2003-7.

for certain aspects of their distributorship, the records apparently were kept merely for substantiation purposes rather than for use as tools to increase the likelihood of profit."[46]

"Actual and honest" profit motive versus "primary purpose"

In determining whether an activity is engaged in for profit, courts apply somewhat different tests in ascertaining a taxpayer's profit objective. Some courts examine whether the taxpayer had an "actual and honest" or "bona fide" profit motive, while others determine if profit was the taxpayer's "primary purpose."[47] Ten of the court cases reviewed cite both the "actual and honest" test and the "primary purpose" test in court's discussion and in making its determination. The courts found that taxpayers in only two cases had a profit motive.[48] In neither of these cases did the Tax Court further analyze whether the taxpayer's profit motive was the primary motive for engaging in the activity.

In only one of the cases reviewed was the "primary test" the only test discussed or mentioned in the court's opinion.[49] This case involved a father managing his teenage daughter's dancing activities. Even though the taxpayer (a lawyer) maintained good records, used a separate checking account for the activity, took courses in entertainment and sports law, spent considerable time and effort in the activity, and consulted experts in the field, the court decided these did not outweigh the inherently personal nature of his activity. In sustaining the IRS' position, the court stated, "...the personal satisfaction to Mr. Carino is so substantial in our view that it constitutes the primary motivation for engaging in the activity, especially where, as here, the possibility of making a profit is so very small."[50]

Even though the "actual and honest" and "bona fide" tests were discussed, the facts and circumstances in some cases led the court to base its opinion on the primary purpose for entering into the activity. For example, in *Baldwin v. Commissioner*[51] the court determined the taxpayer's rental property was not an activity not engaged in for profit, but was purchased primarily as a personal residence or vacation home. The taxpayers submitted

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[46] Lopez v. Comm'r, T.C. Memo. 2003-142

[47] The origin of the "primary test" is traced to case law since neither the Internal Revenue Code, nor the Treasury Regulations, require the taxpayer to show a profit motive was the most important reason for entering into an activity. A 1938 Supreme Court case, Helvering v. National Grocery, Co., 304 U.S. 282, 289 (1938), appears to be where the "primary test" originated even though the case did not explicitly address the issue of the primary profit motive. See, Michelle B. O'Connor, The Primary Profit Objective Test: An Unworkable Standard? 27 Loy. U. Chi. L.J. 491 (1996). Several courts subsequently cited the opinion based on a footnote stating there were many times when "intent" factors into the determination of a tax liability, including "whether the taxpayer's motive in entering into the transaction was primarily profit." See Helvering v. National Grocery, Co., 304 U.S. 282, 289 (1938).

[48] Whitehurst v. Comm'r, T.C. Summ. Op. 2003-7; Schwartz v. Comm'r, T.C. Memo. 2003-86.

[49] Carino v. Comm'r, T.C. Summ. Op. 2002-140.

[50] Id.

[51] Baldwin v. Comm'r, T.C. Memo. 2002-162.

evidence to support their claim that they had an actual profit motive, but could not overcome the court's view that the primary purpose was personal.

In the "actual and honest" test, the courts must decide if the taxpayers had "a" profit motive and do not have to focus on the degree of motivation or determine if the motive was predominant. The courts use the nine factors in Treas. Reg. § 1.183-2(b) to help them determine whether the taxpayer has a profit motive for engaging in the activity. The factors consider different aspects of how the activity was run and what the circumstances were during its operation. The nine factors do not assign a level of motive, but only help in determining if one existed.

The cases litigated this year indicate the courts have given different weight to these tests in making a determination about profit motive.

- Three cases use citations of only the "actual and honest" or "bona fide" test.
- Ten cases cite a combination of "actual and honest" and "primary purpose" tests.
- One case only cites the "primary purpose" test.

In *Lopez v. Commissioner*,[52] the judge uses citations for the "primary," the "bona fide" and the "honest and actual" tests. In practice, then, the courts appear to view the different profit motive tests not as mutually exclusive but as different vantage points on the same issue.

Findings for the Taxpayer

The two cases in which the court decided for the taxpayers have several distinct differences as well as interesting similarities. While the U. S. Tax Court decided both cases, one couple represented themselves *pro se* and the case was heard under the Court's simplified small tax case procedure,[53] whereas the other taxpayers had legal representation and did not qualify for the small tax case procedure because of its limitations on the amount of the deficiency.[54]

In both cases, the Tax Court used the nine factors listed in Treas. Reg. § 1.183-2(b) to determine if the activities were engaged in for profit. The Court discussed each relative factor and determined whether it weighed for or against the taxpayer, or if it was a neutral factor. Although the regulations state no one factor is controlling, the Court discussed the first two factors more extensively than the others, and seemed to place more weight on these factors in making the final determination.

[52] Lopez v. Comm'r, T.C. Memo. 2003-142.

[53] Whitehurst v. Comm'r, T.C. Summ. Op. 2003-7.

[54] Schwartz v. Comm'r, T.C. Memo. 2003-86.

The first factor, the manner in which the taxpayer carries on the activity, received the most attention in these two cases. The Court focused on maintaining books and records, but more importantly on how the taxpayers utilized the information from the books and records. The Court reached similar conclusions for both cases, even though the facts and circumstances were very different.

- In *Schwartz v. Commissioner*,[55] the Court noted that the activity was carried on in a "businesslike manner." The taxpayers maintained a separate checking account, kept a ledger, and generally had good records. The Court also recognized the taxpayer's attempt to increase profitability through a number of actions, including only hiring a crew when needed, refinancing the yacht, changing to a free storage unit, and modifying the yacht to meet new international racing rules.
- In *Whitehurst v. Commissioner*,[56] the taxpayer did not have a separate checking account for the activity, had no ledger or journal, and recorded her expenses by "just jotting information down on the tournament flyer." The Court stated, "While her records were somewhat disorganized and partially incomplete, they generally reflect her receipts and expenses."[57] However, because the taxpayer changed her strategy and reduced expenses by competing in local bowling tournaments with larger prize winnings and ultimately stopped the activity because it was not profitable, the Court supported her claim that she had a profit motive.

The Court also looked favorably on the taxpayers' level of expertise, or if the taxpayers sought information or advice from experts. Both cases cited this factor, as well as each taxpayer's attempt to research the activity and learn about their activity, as a factor that indicated a profit motive. While both of these factors carried great weight with the Tax Court in supporting the taxpayers' claim the activities were engaged in for profit, it is important to note these same two factors weighed heavily against taxpayers in cases in which the IRS prevailed.

CONCLUSION

Treasury Regulation § 1.183-2(b) provides objective standards for evaluating an activity's profit motive. Since determinations in each case are made on its facts and circumstances, including the taxpayer's intent to make a profit, this issue will continue to be contested in the courts.

[55] Schwartz v. Comm'r, T.C. Memo. 2003-86.

[56] Whitehurst v. Comm'r, T.C. Summ. Op. 2003-7.

[57] Id.

The analysis reveals that a wide variety of activities are litigated with respect to the issue of profit motive. Due to the small number of cases litigated and the vast differences in the type of activities, it is difficult to spot any trends that can be remedied through legislative or administrative change. The cases demonstrate, however, the inherent difficulty in drafting legislation and developing clear-cut rules that address taxpayer motive and interest. By necessity, the result in each case turns on the taxpayer's specific facts and circumstances.

LITIGATED

ISSUE #10 MOST LITIGATED ISSUE: INTEREST DEDUCTIONS

SUMMARY

Twelve tax cases that included interest expense deduction issues were litigated in the federal courts between June 1, 2002, and May 31, 2003. Nine of these cases were decided in the IRS' favor, with the taxpayer prevailing in one case, and split decisions in two cases. In four of the 12 cases, taxpayers represented themselves in court, *pro se*, with two of the cases resulting in split decisions, and the IRS prevailing in the other two *pro se* cases.

Internal Revenue Code section 163(a) provides for a deduction for all interest paid or accrued on indebtedness within the taxable year. Limitations on investment interest are defined in IRC § 163(d), and a disallowance of deduction for personal interest is addressed in IRC § 163(h). An exception to the disallowance for personal interest, including qualified residence interest, is addressed in IRC § 163(h)(2). A review of this year's litigated cases reveals no common theme that could be remedied legislatively or administratively.

PRESENT LAW

Taxable income is defined as gross income minus the deductions allowed by Internal Revenue Code section 63, which includes itemized deductions.[1] Interest, which is the amount owed to a lender in return for the use of borrowed money,[2] is allowed as an itemized deduction.[3] The types of interest taxpayers can deduct on Schedule A (Form 1040) are home mortgage interest, including certain points,[4] investment interest,[5] and in certain cases, interest on qualified educational loans.[6] The deduction for investment interest expense is limited by investment income.[7]

[1] IRC § 163(d) defines itemized deductions as the deductions allowed by this section other than the deductions allowable in arriving at adjusted gross income and the deduction for personal exemptions provided by IRC § 151.

[2] *Black's Law Dictionary* 816 (7th ed. 1999).

[3] IRC § 163(a).

[4] IRC § 461(g)(2) provides an exception to the general rule that for taxpayers on the cash receipts and disbursement method of accounting, prepaid interest is treated as being paid in the year to which the expense is allocable. IRC § 461(g)(1).

[5] IRC § 163(d).

[6] IRC § 163(h)(2)(F).

[7] IRC § 163(d) limits the amount allowed as a deduction (in the case of a taxpayer other than a corporation) to net investment income as defined in IRC § 163(d)(4).

Business taxpayers, both individual and corporate, are entitled to a deduction for interest expenses.[8] Interest expense allocated to a trade or business expenditure is taken into account under IRC § 163(h)(2)(A).[9] "Trade or business expenditure" means an expenditure (other than a passive activity expenditure or an investment expenditure) in connection with the conduct of any trade or business other than the trade or business of performing services as an employee.[10] Interest paid on underpayments of individual federal taxes and on indebtedness used to pay taxes is defined by Treas. Reg. § 1.163-9T as non-deductible personal interest, regardless of the source of the income generating the tax liability.[11]

An interest expense deduction involving related taxpayers requires the matching of the payer's interest expense deduction with the interest income item by the payee.[12] When different methods of accounting are used by related taxpayers, accrued expenses cannot be deducted by the payor until the expense is includible in the gross income of the recipient.[13]

ANALYSIS OF LITIGATED CASES

There were 12 cases with interest expense issues litigated in the federal court system between June 1, 2002, and May 31, 2003. Two cases involved non-business interest expense, and 10 cases included disputes involving business interest expense deductions. A detailed listing of the cases is found in Table 10 in Appendix 2.

Taxpayers represented themselves before the courts (*pro se*) in four of the 12 cases. One of the four *pro se* cases was a non-business interest case; the others were business interest cases. Split decisions were entered in two of the *pro se* cases, and decisions sustaining the IRS position were made in the other two. The split decision *pro se* cases involved:

- A taxpayer who claimed repayment of loan principal as a business expense deduction, but was allowed the interest paid on the loan as a business interest expense deduction,[14] and
- A taxpayer who substantiated an additional mortgage interest expense of $414, but was unable to substantiate all of the other types of personal itemized deductions.[15]

[8] IRC § 163. Additional Itemized Deductions for Individuals and Corporations are found in IRC §§ 161-221.

[9] Treas. Reg. § 1.163-8T(a)(4)(i)(A).

[10] Treas. Reg. § 1.163-8T(b)(7).

[11] Treas. Reg. § 1.163-9T(b)(2)(i)(A).

[12] IRC § 267(a)(2).

[13] Id.

[14] Huang v. Comm'r, T.C. Summ. Op. 2002-93.

[15] Guarna v. Comm'r, T.C. Summ. Op. 2003-65.

The IRS position was sustained in pro se cases:

- Where mortgage interest expense was claimed on a loan that was not secured by a personal residence,[16] and
- Where the taxpayers, who had attempted to pay personal living expenses through an alleged ministry they controlled, failed to substantiate the expenses claimed on their Schedule A and Schedule C.[17]

Of the eight taxpayers who were represented by counsel, the courts sustained the IRS position in seven cases, and the taxpayer prevailed in one. Again, one of the cases in which taxpayers were represented by counsel involved non-business interest and the remaining cases involved business interest.

Two cases involved the question of deductibility of interest paid by corporations on indebtedness for corporate owned life insurance policies.[18] The taxpayer prevailed in one case[19] and the IRS position was upheld in the other, where the life insurance plan was held to be an economic sham.[20]

Taxpayers made various challenges to IRS determinations in the nine cases where the IRS position was sustained, including:

- The taxpayer challenged the IRS regulation that determined interest expense paid on a tax deficiency from a prior year audit was personal interest.[21]
- The taxpayers, and their wholly owned corporation, disagreed with the IRS position that the husband received constructive dividends instead of interest payments from his corporation because the corporate debt was not bona fide.[22]
- The taxpayer challenged the IRS determination that no deduction was allowed under IRC § 267(a)(2) for interest that had accrued but was unpaid on a note to a related party after the note was sold to an unrelated party and the prohibited relationship was eliminated.[23]

Below are summaries of some of the cases that are included among the litigated cases during the analyzed time period.

[16] Boehme v. Comm'r, T.C. Memo. 2003-81.

[17] Smith v. Comm'r, T.C. Summ. Op. 2003-16.

[18] IRC § 264(a)(2) states that no deduction shall be allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

[19] Dow Chemical Co. v. United States, 250 F. Supp. 2d 748 (E.D. Mitch 2003), modified by 278 F. Supp. 2d 844 (E.D. Mich. 2003).

[20] Internal Revenue Service v. C.M. Holdings, Inc., 301 F.3d 96 (3d Cir. 2002).

[21] Robinson v. Comm'r., 119 T.C. 44 (2002).

[22] Boler v. Comm'r, T.C. Memo. 2002-155.

[23] Ronald Morgan Cadillac, Inc. v. United States, 90 A.F.T.R. 2d (RIA) 6719 (C.D. Cal. 2002).

In *Boehme v. Commissioner*,[24] the taxpayers had won the Colorado State Lottery and sometime later they obtained a loan that was secured by 12 future lottery payments. In the year before the court, the taxpayers assigned their right to the 12 future lottery payments to the lender in exchange for a lump sum payment of $400,000. The taxpayers used a portion of that lump sum to repay the principal and interest on the loan. The issues for the Tax Court were: (1) whether the amount the taxpayers received in exchange for the assignment of the right to receive future lottery payments was ordinary income or capital gain, and (2) whether the taxpayers were entitled to deduct an amount paid in connection with the repayment of loans that were secured by the lottery winnings.

The Tax Court held that: (1) the taxpayers' right to receive 12 future lottery payments was not a capital asset within the meaning of IRC § 1221; (2) the lump sum received by the taxpayers in exchange for the assignment of that right was ordinary income, and (3) that the interest paid was personal interest and not deductible.

The taxpayers sought to deduct the interest paid on the loan because at least a portion of the loan was used to improve the taxpayers' residence. However, the loans were not secured by their residence as required by IRC § 163(h)(3)(B)(i)(II). The Court determined that the interest was not qualified residence interest. As a result, the interest did not qualify as an exception to personal interest under IRC § 163(h)(2)(D).

The taxpayers also argued that at least a portion of the interest payment was deductible as interest paid on an indebtedness allocated to property held for investment (i.e., the annuity purchased by the Colorado State Lottery to fund the lottery payments) pursuant to IRC § 163(h)(2)(A). The Court determined that the Colorado State Lottery, not the taxpayers, held the annuity. Thus, no portion of the interest was deductible as interest paid on indebtedness allocated to property held for investment.

Finally, the taxpayers argued that the interest was deductible under IRC § 163(h)(2)(A) as interest on indebtedness properly allocable to a trade or business. This apparently was an attempt by the taxpayers to connect the improvements made to the home to the conduct of the wife's operation of a custom painting business out of the home. The Court concluded that the evidence did not support the taxpayers' argument and ruled that no portion of the interest paid was deductible.[25]

The issue in *Lenehan v. Commissioner*[26] was whether investment income as defined by IRC § 163(d)(4)(B) included a long-term capital loss carryover for purposes of calculating the

[24] Boehme v. Comm'r. T.C. Memo. 2003-81.

[25] Id.

[26] Lenehan v. Comm'r., T.C. Summ. Op. 2002-124.

limitation on the investment interest expense deduction. The IRS had disallowed $21,677 of the taxpayers' $26,721 investment interest expense deduction. The basis for the disallowance was that the deductible amount was limited to the taxpayers' net investment income of $5,044. The IRS determined that the taxpayers' loss carryover of $141,621 was an item of investment income and, therefore, resulted in the taxpayers having zero net gain, zero net capital gain, and net investment income of $5,044.

The Tax Court held that the taxpayers' loss carryover was an item of investment income under IRC § 163(d)(4)(B).[27] Accordingly, the loss carryover served to limit the taxpayers' investment interest expense deduction to $5,044. The Tax Court reasoned that had it adopted the taxpayers' interpretation of IRC § 163(d), the carryover would be used to reduce the net capital gain but would not be used to limit taxpayers' net investment income. Under this scenario, the taxpayers would be able to decrease gross income by using the carryover and increase deductions from gross income by ignoring the carryover. The inconsistent treatment would result in a double benefit not permitted under IRC § 163(d).[28] The Tax Court found in favor of the Commissioner.

In *Boler v. Commissioner*,[29] a husband and wife and the husband's wholly owned corporation disagreed with the IRS' determination that the corporation's payments to the husband were constructive dividends[30] instead of interest payments. The corporation deducted the payments as a business expense. However, the IRS determined that no bona fide loan existed between the taxpayers and the corporation.

[27] IRC § 163(d)(4)(B) defines the term investment income as the sum of (i) gross income from property held for investment (other than any gain taken into account under clause (ii)(I), (ii) the excess (if any) of -(I) the net gain attributable to the disposition of property held for investment, over (II) the net capital gain determined by only taking into account gains and losses from dispositions of property held for investment, plus (iii) so much of the net capital gain referred to in clause (ii)(II) (or, if lesser, the net gain referred to in clause (ii)(I)) as the taxpayer elects to take into account under this clause.

[28] Lenehan v. Comm'r, T.C. Summ. Op. 2002-124.

[29] Boler v. Comm'r, T.C. Memo. 2002-155.

[30] "Constructive Dividend" means "A taxable benefit derived by a shareholder from the corporation even though the benefit was not designated a dividend." *Black's Law Dictionary* 492 (7th ed. 1999).

The only documents that showed that the corporation owed money to the husband were the promissory note and the corporate tax return. The other documentary evidence, including the corporate balance sheet, applications to state licensing boards, and loan applications, did not show that the corporation owed the husband for the purchase of the assets, although the property was listed as an asset of the corporation. The Tax Court held that under these circumstances, the promissory note was not evidence of the alleged loan, and did not establish a bona fide debt. The payments by the corporation to the husband were constructive dividends and not deductible by the corporation as interest expense.

The taxpayer, in *Ronald Morgan Cadillac, Inc., v. United States*,[31] an accrual basis auto dealership, brought a civil action for refund of income taxes under IRC § 7422. The taxpayer obtained a loan from its sole shareholder, who was on the cash receipts and disbursements method of accounting. The taxpayer accrued the interest that was due on the note but did not pay over the interest to the shareholder. Under IRC § 267(a)(2), the taxpayer was prohibited from deducting accrued but unpaid interest that was owed to a related party.

The shareholder subsequently sold the note to an unrelated third party. On the corporate return filed for the year of the sale, the taxpayer claimed a deduction not only for the accrued interest from the year of the sale, but for the accrued but unpaid interest for the prior years. This deduction resulted in a net operating loss that the taxpayer sought to carry back to earlier years.

The taxpayer argued that once the shareholder sold the note, eliminating the related party restrictions, all the accrued interest, including accruals prior to the year of sale, were deductible. The IRS contended that once IRC § 267(a)(2) applies to a tax year, it continues to apply and cannot be eliminated because the parties are no longer related. The district court upheld the IRS's position that the taxpayer was not entitled to deduct the prior year accrued interest expense until payment was made.

The taxpayers, in *Robinson v. Commissioner*[32] challenged the determination of the IRS that interest expense claimed on Schedule C was subject to Internal Revenue Code section

[31] Ronald Morgan Cadillac, Inc. v. United States, 90 A.F.T.R. 2d (RIA) 6719 (C.D Cal. 2002).

[32] Robinson v. Comm'r, 119 T.C. 44 (2002).

163(h), which disallows a deduction for personal interest. The deduction at issue was interest paid on an underpayment of individual income tax liability resulting from a prior year audit, and largely attributable to adjustments on the prior year's Schedule C.

The petitioners contended that the interest was paid on indebtedness properly allocable to a trade or business,[33] and was exempt from the general disallowance rule. They further contended that Treas. Reg. §1.163-9T[34] was invalid, relying on prior Tax Court decisions that supported their position. Their alternative position was that the regulation was not an authoritative interpretation of the statutory language because the regulation was issued before the statutory language was enacted.

The IRS position was that the regulation was a valid interpretation of an ambiguous statute. The IRS cited legislative history in support of the validity of the regulation.[35] For example, the IRS noted that the May 4, 1987, "Blue Book" published by the Joint Committee on Taxation,[36] states that, "Personal interest also includes interest on underpayments of individual federal, state or local income taxes, notwithstanding that all or a portion of the income may have arisen in a trade or business."[36] IRS noted that five Circuit Courts of Appeal had determined that the regulations were not invalid, and contended that previous IRC § 163(h) case law was not relevant to resolving the Robinson case.

In a court reviewed opinion, a divided Tax Court found in favor of the Commissioner, concluding that, "taking into account the uncertainty as to the meaning of the statute, even as informed by the history of the legislation, these regulations constitute a permissible interpretation of the statute."[37] Therefore, the interest paid by the taxpayers was personal interest and not deductible under IRC § 163(h)(2).

[33] IRC § 163(h)(2)(A). The term personal interest means any interest allowable as a deduction under this chapter other than interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services to an employee).

[34] Treas. Reg. § 1.163-9T states that no deduction shall be allowed for personal interest paid or accrued by a taxpayer other than a corporation and defines personal interest to include interest paid on underpayments of individual Federal taxes and on indebtedness used to pay such taxes.

[35] Robinson v. Comm'r, 119 T.C. 44 (2002) at 7.

[36] Joint Committee on Taxation, General Explanation Of The Tax Reform Act Of 1986 H.R.3838, 99th Congress; Pub. L. 99-514, May 4, 1987.

[37] Robinson v. Comm'r, 119 T.C. 44, 49 (2002).

CONCLUSION

We do not recommend any changes in legislation in the area of interest expense deductions at this time. The cases litigated between June 1, 2002, and May 31, 2003 involved a range of issues, from a simple lack of substantiation, to a disallowance of interest expense involving IRC § 267 related taxpayers, to disallowance of alleged interest payments determined to be constructive dividends.

INTRODUCTION

The Taxpayer Advocate Service is responsible for resolving taxpayer problems on both a case-by-case and a systemic basis. TAS is working to integrate advocacy into all aspects of its work. Whether working on a specific case or on a systemic problem, TAS conducts an independent analysis of the circumstances, makes an impartial evaluation of each case, and maintains appropriate confidentiality. We strengthened these tools and capacities in FY 2003, with taxpayers benefiting greatly from improvements in both the handling of individual cases and in overall advocacy.

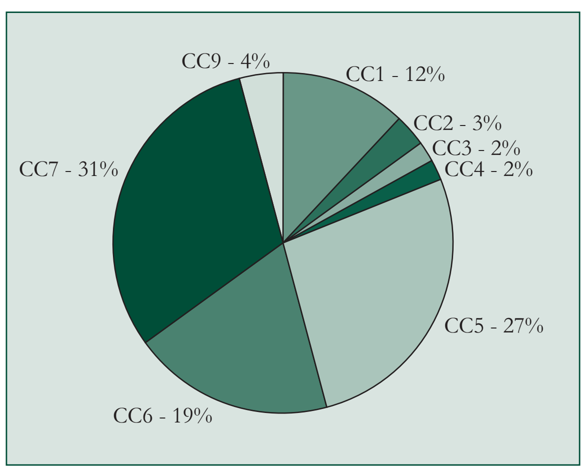
CASE ADVOCACY

Case Receipts

Internal Revenue Code section 7811(a) specifically defines the types of hardships that taxpayers might experience and that would meet criteria for TAS intervention. These definitions align themselves into two broad categories of hardship: 1) economic or financial, and 2) procedural or systemic. Historically, and for FY 2003, most taxpayers contacted TAS because of systemic or procedural problems with the Internal Revenue Service (including delays). Eighty-one percent of our receipts met this category. The remaining 19 percent were the result of economic or financial situations, an increase from 15.4 percent in FY 2002. We will continue to monitor this trend in financial hardship cases.

The Taxpayer Advocate Service received 196,040 new cases in FY 03 from taxpayers, practitioners, and referrals by the IRS operating divisions, and Congressional offices. Chart 4.1 illustrates TAS FY 03 receipts by Criteria Code (CC):

CHART 4.1, TAS FY 03 RECEIPTS BY CRITERIA CODE (CC):



FINANCIAL OR ECONOMIC HARDSHIP

CC 1: taxpayer suffering or about to suffer a significant hardship (IRC § 7811(a)(1)(A)) – 12%
CC 2: taxpayer facing threat of adverse action (IRC § 7811(a)(2)(A)) – 3%
CC 3: taxpayer will incur significant costs if relief is not granted (IRC § 7811(a)(2)(C)) – 2%
CC 4: taxpayer will suffer irreparable injury or long term adverse impact (IRC § 7811(a)(2)(D)) – 2%

SYSTEMIC OR PROCEDURAL HARDSHIP

CC 5: taxpayer experienced a delay of more than 30 days to resolve tax account problem (IRC § 7811(a)(2)(B)) – 27%
CC 6: taxpayer has not received a response by the date promised – 19%
CC 7: System(s) or procedure(s) either failed to operate as intended or failed to resolve the taxpayer's problem – 31%
CC 9: Any case not meeting specific TAS criteria, including duplicate congressionals, but warranting TAS intervention – 4%

In April 2003, TAS enhanced its management information system.[1] As part of this process, we expanded the former major issue codes, both in specificity of issue and in the number of identifiable issues (see Appendix 1). To compare the data used in this report to that from the last fiscal year, we have converted the expanded list of core issue codes into the major issue codes.

Table 4.2 illustrates the top 10 case issues received in TAS this fiscal year, representing approximately 66 percent of all new FY 2003 cases.

TABLE 4.2, TOP TEN ISSUES RECEIVED IN TAS IN FY 03

Rank	Description of Issue	Cases
1	Revenue Protection-EITC (refunds frozen pending IRS determination to examine the return)	25,679
2	Processing Claims/Amended Returns	23,233
3	Refund Inquiry	17,161
4	Criminal Investigation	15,118
5	Initial Processing Individual Tax Returns	9,483
6	Levies	9,228
7	Penalties (failure to pay, failure to file, estimated tax)	7,936
8	Audit Reconsiderations	7,744
9	Underreporter Process (includes both open and closed cases)	7,630
10	Problems with Payments and Credits	5,990
	Total	**129,202**

[1] TAS uses the Taxpayer Advocate Management Information System (TAMIS) to track cases.

The most common issues in TAS cases have changed very little over the last four years. Earned Income Tax Credit (EITC) examinations continue to be a significant source of TAS casework.[2] The vast majority (76.4 percent) of these receipts stem from taxpayers' frustration and hardships because they have not received accurate or timely responses in the examination of their claim for EITC.

Trends in TAS Case Receipts

Criminal Investigation Cases

During FY 2003, TAS experienced a dramatic (175 percent) increase in taxpayer cases resulting from the IRS' growing effort to detect fraud.[3] The Criminal Investigation (CI) function administers this program, and each of the 10 IRS processing campuses has a fraud detection center. The IRS suspends refunds while CI reviews suspect returns. If the income and tax withholding are verified, the refund is released to the taxpayer. If the return is not verified as accurate, the account is referred to either a special agent to pursue as a criminal case or the examination function for audit.

Over 15,000 taxpayers contacted TAS as a result of the hardships they experienced because the IRS held their refunds or failed to process their returns as part of the increased fraud detection program. Eighty-nine percent of these taxpayers (13,441) failed to have their cases resolved within normal processing timeframes. In cases where the return was verified, TAS was successful in obtaining expedited refunds to taxpayers experiencing financial hardships.

The Taxpayer Advocate Service and IRS Criminal Investigations division are finalizing negotiations on a service level agreement. Through this agreement, both TAS and CI acknowledge the importance of their respective missions and agree to work together to provide taxpayers priority treatment when they experience significant hardship.

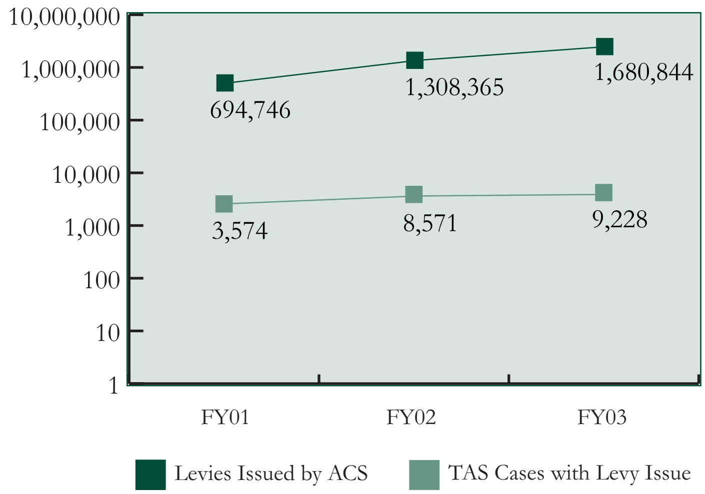
Lien and Levy Cases

New cases resulting from lien and levy enforcement actions have also increased in the past three fiscal years. The number of taxpayers who have contacted TAS due to hardships caused by levy actions has risen from 3,574 in FY 01 to 9,228 in FY 03, a 156 percent increase. This is comparable to the overall increase (142 percent) in levies over the last two fiscal years. Chart 4.3 below illustrates the number of levies issued by the IRS compared to the number of TAS levy receipts for the last three fiscal years.

[2] For a discussion of IRS EITC Compliance Strategy, see *supra page part 1* .

[3] See *supra part 1* for a more detailed discussion of criminal investigation cases.

CHART 4.3, IRS LEVIES ISSUED VERSUS LEVY CASES RECEIVED IN TAS



TAS Declining Case Receipts

TAS receipts decreased by 14 percent (31,333 cases) in FY 03. Ninety-three percent (29,231 cases) of this decrease can be attributed to cases involving systemic or procedural problems (TAS Criteria Code 5-7 cases). This suggests TAS involvement in resolving systemic problems and improving IRS processes is beginning to show positive results. One example is our successful effort to streamline and make consistent the processes utilized by IRS at its campuses (formerly called service centers).[4] Table 4.4 below shows the top five areas where TAS Criteria Code 5-7 (Systemic) cases decreased in FY 03.

TABLE 4.4, TOP FIVE TAS CRITERIA CODE 5-7 CASE DECREASES BY ISSUE

Description of Issue	FY 02	FY 03	Decrease	% Change
Processing Claims & Amended Returns	26,443	19,021	7,422	-28%
Original Processing of Individual Tax Returns	11,659	7,765	3,894	-33%
Lost/Stolen Refunds	6,710	3,252	3,458	-51%
Other Refund Inquiry (explanation of status or expedite request)	13,966	10,624	3,342	-24%
Penalties (failure to pay, failure to file, estimated tax)	10,582	7,398	3,184	-30%

Although TAS has experienced a decrease in claims and amended return cases over last fiscal year, they remain a large percentage of our workload.[5] During FY 2004, TAS will be partnering with the Small Business/Self-Employed Operating Division (SB/SE) to survey a sample population of taxpayers who recently experienced hardships when their amend-

[4] Campus Consistency Project Report. The Campus Consistency Project is identifying inconsistent processing procedures among IRS campuses. These inconsistencies frustrate taxpayers, their representatives, and IRS employees. For an example of how the Campus Consistence Project helped identify systemic problems, see p. "Manual Refund Inconsistencies." *Supra Part 1.*

[5] Amended return cases accounted for 56 percent of the top five Criteria 5-7 cases in FY 03.

ed returns were filed and processed. This survey will provide key information for systemic improvements.

Case Closures

Taxpayer Advocate Service employees closed 205,053 cases this past fiscal year, 196,619 of which originated as Applications for a Taxpayer Assistance Order (ATAO) (Form 911 or acceptable substitute), either in FY 03 or in prior years. The remaining closed cases represent duplicate Congressional inquiries and cases that did not meet specific TAS hardship criteria. We provided partial or full relief in 65.9 percent of cases received as ATAOs. Table 4.5 details the Application for Taxpayer Assistance Order cases that closed in FY 03.

TABLE 4.5, APPLICATION FOR TAXPAYER ASSISTANCE ORDER CASE DISPOSITION

Description of Disposition	Number of Cases	% of Total
Relief Granted- Including Taxpayer Assistance Orders	120,558	61.3%
Partial Relief Granted	9,103	4.6%
No Relief Granted - Advocate does not deem relief appropriate.	39,678	20.2%
No Relief Granted- No response from taxpayer.	13,459	6.9%
No Relief Granted- Hardship not validated or documentation/verification that the Advocate deems necessary not provided by taxpayer.	1,652	0.8%
No Relief Granted- Advocate determined relief appropriate, but current law prevents granting relief.	1,574	0.8%
Advocate Relief Not Required- Relief provided by Operations prior to receipt of ATAO or relief determination.	7,109	3.6%
Advocate Relief Not Required- Taxpayer rescinds ATAO, no longer requires Advocate relief.	2,195	1.1%
Advocate Relief Not Required- Taxpayer hardship did not involve in any way the administration of internal revenue laws.	1,081	0.6%
Not Identified	210	0.1%
Total	**196,619**	**100%**

Our business results show we have improved our case quality and shortened the length of time needed to resolve a taxpayer's problem. In an independent survey conducted by the Gallup Organization, taxpayers whose cases are resolved within 90 days are generally more satisfied with TAS. During FY 03, and continuing this year, TAS focused on eliminating delays – whether they were caused by the IRS, the taxpayer, or by TAS. The Gallup survey also indicated that 59 percent of TAS "customers" have a more favorable opinion of the IRS as a whole after TAS intervened on their behalf.[6]

[6] Gallup Organization *Customer Satisfaction Survey*, Cumulative Quarter, Ending March 31, 2003.

Taxpayer Assistance Orders

Internal Revenue Code section 7811 authorizes Local Taxpayer Advocates (LTAs) to issue a Taxpayer Assistance Order (TAO) when a taxpayer is suffering or about to suffer a significant hardship as a result of the IRS' administration of tax laws. Taxpayer Assistance Orders fall into two broad categories: The Direct TAO requires an IRS unit to take an action specifically authorized by IRC § 7811(b).[7] A Review TAO requires an IRS unit to expedite consideration of a taxpayer's case, review and reconsider its own determination, or review the determination at a higher level in that unit.

During FY 03, TAS issued twelve Taxpayer Assistance Orders to:

- Prevent levy action on a business' bank accounts and account receivables;
- Determine the appropriateness of a preparer penalty assessment;
- Reconsider a previous audit determination;
- Request withdrawal of a Notice of Federal Tax Lien;
- Remove an accuracy related penalty;
- Request the correction of accounts that resulted from the IRS erroneously merging two accounts;
- Request subordination of a Notice of Federal Tax Lien (two cases);
- Process an amended tax return;
- Correct a taxpayer's account to reflect the agreed deficiency assessment; and
- Request a release of a wage levy (two cases).

IRS completed the requested actions on 10 of the TAOs and appealed the other two. The National Taxpayer Advocate rescinded one TAO because TAS had insufficient documentation to support the requested action. The other was rescinded because the IRS took the requested action before the responsible official received the TAO.

Section 7811(b) further provides that the TAO may require the action(s) to be taken within a specified timeframe. All 12 TAOs had timeframe requirements. In addition to the two that were rescinded, four were completed within the requested timeframe, and the remaining six were completed within ten days of the requested timeframe.

Congressional Casework

TAS is responsible for independently reviewing all tax account-related inquiries sent to the IRS by members of Congress. These inquiries need not meet the definition of significant hardship found in IRC § 7811(a)(2). TAS answered more than 14,200 Congressional inquiries during FY 03, of which 12,885 did meet the statutory significant hardship criteria.

[7] This might include such actions as releasing a taxpayer's property from levy or ceasing the filing of a notice of federal tax lien.

Table 4.6 highlights the case disposition of these hardship inquiries. The remaining Congressional inquiries either did not meet hardship criteria or were identified as cases with multiple inquiries on the same taxpayer and issue.

TABLE 4.6, CONGRESSIONAL CASEWORK DISPOSITION

Application for Taxpayer Assistance Order (ATAO) Disposition	Number of Cases	% of Total
Relief Granted- Including Taxpayer Assistance Orders	6,780	52.6%
Partial Relief Granted	721	5.6%
No Relief Granted- Advocate does not deem relief appropriate.	3,407	26.4%
No Relief Granted- No response from taxpayer.	520	4.0%
No Relief Granted- Hardship not validated or documentation/ verification that the Advocate deems necessary not provided by taxpayer.	49	0.4%
No Relief Granted- Advocate determined relief appropriate, but current law prevents granting relief.	208	1.6%
Advocate Relief Not Required- Relief provided by Operations prior to receipt of ATAO or relief determination.	772	6.0%
Advocate Relief Not Required- Taxpayer rescinds ATAO, no longer requires Advocate relief.	141	1.1%
Advocate Relief Not Required- Taxpayer hardship did not involve in any way the administration of internal revenue laws.	230	1.8%
Not Identified	57	0.4%
Total	**12,885**	**100%**

The issues raised most frequently by taxpayers seeking Congressional intervention in FY 03 included refund issues, levies, offers in compromise, abatement of penalties, ongoing examinations, processing original tax returns, processing claims for amended returns, earned income tax credit examinations, inability to pay, and audit reconsiderations.

Senate Finance Committee

While the Senate Finance Committee continues to receive IRS related inquiries, it is forwarding fewer to TAS for resolution. In fiscal year 2003, five new cases were referred from the Senate Finance Committee to the TAS, down from 17 in FY 2002 and 68 in FY 2001. All five cases involved offer in compromise issues.

In FY 03, TAS closed 10 Senate Finance Committee cases that originated in either FY 03 or in prior years. Table 4.7 shows the disposition of these cases.

TABLE 4.7, SENATE FINANCE COMMITTEE CASEWORK DISPOSITION

Application for Taxpayer Assistance Order (ATAO) Disposition	Number of Cases	% of Total
Relief Granted	5	50%
Partial Relief Granted	1	10%
No Relief Granted- Advocate does not deem relief appropriate.	2	20%
No Relief Granted- No response from taxpayer.	1	10%
No Relief Granted- Hardship not validated or documentation/verification that the Advocate deems necessary not provided by taxpayer.	1	10%
Total	**10**	**100%**

SYSTEMIC ADVOCACY

Introduction

Many issues are systemic in nature rather than isolated to only a few taxpayers. Systemic Advocacy addresses these areas through analysis, interaction with other IRS components and external stakeholders, and recommendations for resolving problems. During FY 2003, the TAS Office of Systemic Advocacy greatly expanded its capacity for issue intake, principally through the full implementation of the Systemic Advocacy Management System (SAMS),[8] and the realignment of staff resources.

The National Taxpayer Advocate identified "Integrating Advocacy" throughout the entire TAS organization as a major objective for fiscal years 2003 and 2004. This initiative capitalizes upon the knowledge and abilities of the Local Taxpayer Advocates to champion issues of nationwide importamce. LTAs will each be assigned a "portfolio" of issues for which they will be the acknowledged subject matter experts. They may advise the National Taxpayer Advocate on issues related to their portfolio, represent TAS on appropriate task forces and before stakeholder groups, and contribute to the Annual Report to Congress. The Office of Systemic Advocacy will provide staff support, technical analysis, and coordination.

Systemic Advocacy Receipts

The Office of Systemic Advocacy received over 900 submissions through the SAMS system during the calendar year. Graph 4.8 illustrates monthly receipts in the Office of Systemic Advocacy since January 2003. Approximately 30 percent of these submissions came directly from tax -professionals, individual taxpayers, and others. As Chart 4.9 illustrates, inventory was especially sizeable in collection- related issues, and in those issues associated with processing of tax returns. We anticipate that receipts will increase substantially during FY04, as we continue to publicize and refine the system and enhance its capabilities.

[8] SAMS is a database of advocacy issues and projects submitted to TAS by IRS employees and the public. The Internet version of SAMS is available through the Systemic Advocacy pages of the TAS website at http://www.irs.gov/advocate/index.html.

GRAPH 4.8, MONTHLY RECEIPTS IN SYSTEMIC ADVOCACY

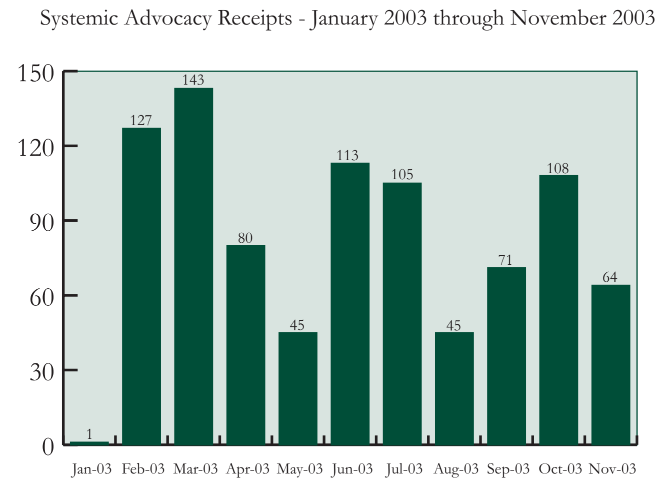
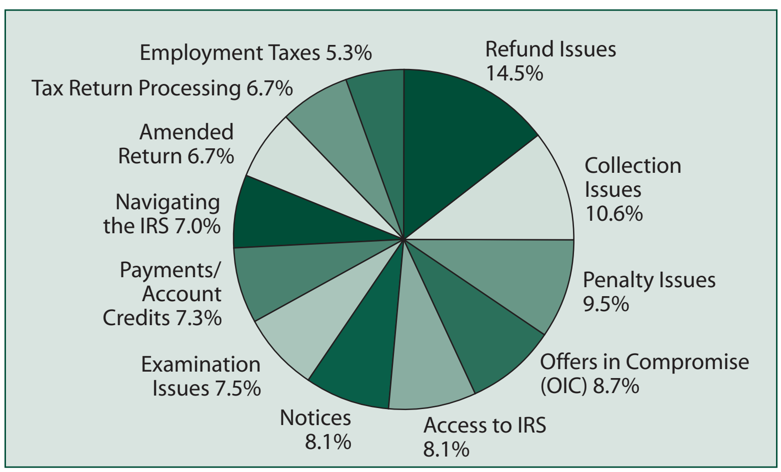


CHART 4.9, TOP CATEGORIES OF ISSUES SUBMITTED VIA SAMS IN FY 03



Operational Priorities

Systemic Advocacy has two major components: business advocacy, and individual advocacy. Each division is charged with identifying broad issues which impact upon its stakeholders, evaluating relevant data, and proposing administrative or statutory remedies as appropriate. During FY03, we considered the following submissions for advocacy projects categorized in Table 4.10.

TABLE 4.10, SYSTEMIC ADVOCACY MANAGEMENT SYSTEM (SAMS): TOP 12 MAIN CATEGORIES & SUB-CATEGORIES SUBMITTED IN FISCAL YEAR 2003

Rank	Main Categories	Sub-Categories
1	Refund Issues	Refund Statute of Limitations
		Refunds: Direct Deposit
		Refunds: Erroneous
		Refunds: Freezes
		Refunds: Lost/Stolen Refund
		Refunds: Offset
2	Collection Issues	Collection Statute of Limitations Period
		Collection Due Process
		Levy
		Lien
		Installment Agreements
3	Penalty Issues	PEN: Trust Fund Recovery Penalty
		Failure to Deposit (FTD) Penalty
4	Offers in Compromise (OIC)	
5	Access to IRS	
6	Notices	Combined Annual Wage/(CAWR)/Program-Notice
		Instructions
7	Examination Issues	Audit Reconsideration (EXAM)
8	Payments/Account Credits	Payments: Misapplied
		Estimated Tax Payments
		Federal Payment Levy Program (FPLP)
9	Navigating the IRS	
10	Amended Return	
11	Tax Return Processing	Processing: Math Error
		Processing: RejectedReturn
12	Employment Tax Issue	Independent Contractor vs. Employer

Advocacy Projects

Many of the issues involving individual or business taxpayers TAS worked on during fiscal year 2003 are discussed in detail in the Most Serious Problems section of this report.[9] The following discussion highlights a sample of Systemic Advocacy activity in this area.

[9] These topics include the Earned Income Tax Credit, Individual Taxpayer Identification Numbers, Offers In Compromise, Combination Letters, and Collection Due process, among others.

Earned Income Tax Credit - Certification Initiative

Analysts worked with the IRS through each stage of the precertification task force and presented a taxpayer focused point of view on issues involving affidavits, processing norms, methodology, and forms design.

Examination Redesign - Our technical input and focus on compressing timeframes have been critical to this ongoing effort. TAS strongly supports the goal of limited issue focus examinations in the EITC arena.

Multi-lingual Issues

Systemic Advocacy's focus in this area was to ensure that among the "vital documents" translated into Spanish were any that had the potential to deprive taxpayers of property or earnings. This primarily involved distraint action (levy, seizure, notice of proposed assessment). More broadly, it included translating forms and notices for populations with substantial Spanish speaking membership (especially EITC related documents).

Taxpayer Assistance Centers

Financial constraints and technological advances have led the IRS to consider curtailing the services offered at "walk-in" sites throughout the nation. We believe that the tax system is best served through maximum access to both information and services. We also submit that many citizens lack either familiarity with or access to automated services. Systemic Advocacy worked cooperatively with the Wage and Investment Operating Division to emphasize this perspective and urge a reconsideration of the more extreme options.

Campus Consistency Project

Systemic Advocacy is leading the Campus Consistency Project, an effort to alert both the Wage and Investment, and Small Business/Self-employed Employed Division to the inconsistent procedures for resolving tax disputes that exist among their various campus (service center) locations. Many of the discrepancies correspond to the issues identified through both the SAMS and TAMIS systems and frustrate taxpayers, their representatives, and IRS employees. Since it is now not uncommon for tax professionals to deal with a number of campus locations, their dissatisfaction is understandable.

Appeals Issues

TAS has focused on several aspects of the Appeals process. In particular, we have identified inventory, cycle time, collection due process, mediation and the more fundamental issue of independence as areas for scrutiny. Our concern is the impact, both potential and actual, of these issues on the taxpayers.

Federal Tax Deposit Penalties / Misapplication Of Payments

We worked extensively with the Large and Mid-size Size Business (LMSB) Operating Division to address the issue of FTD requirements for employment taxes and the misapplication of FTD payments. It impacts almost exclusively upon large corporations with numerous subsidiaries, and entails extensive work for both the taxpayer and the IRS.

Small Business Outreach

Through our Small Business Liaison, we have established a vigorous program of outreach to this community. At the request of the IRS oversight board, we focused upon some of the smallest businesses that had the greatest most need of for our assistance. As such, we made substantive contacts with business and trade associations, chambers of commerce, and serve as the TAS delegate for Small Business Adminstration hearings.

TOP 25 MAJOR ISSUES FOR FY 2003 IDENTIFIED ON TAMIS

MI Code	Description	Total
471	Revenue Protection-EITC	25,679
330	Processing claims/amended returns	23,233
020	Refund Inquiry including expedited request	17,161
474	Open Criminal Investigation Freeze	15,118
310	Initial Processing of IMF return	9,483
741	Levies	9,228
511	Other Penalties	7,936
620	Audit Reconsiderations	7,744
430	Underreporter process-includes both open & closed cases	7,630
210	Problems with payments/credits (other than ftd/eftps,&excess coll.)	5,990
610	Examination of tax return in progress prior to assessment on AIMS	5,913
790	Other-no other MI Code applies	4,176
010	Lost/stolen refunds-entire check tracing process	3,944
771	OIC	3,765
742	Liens	3,501
420	Request for forms, transcripts, returns	2,894
460	Offsets made to tax liabilities or Federal or stage agencies	2,802
773	Other collection issues	2,413
730	Notices issued prior to ACS or Collection Field Operation & no other MI Code appropriate	2,347
475	ITIN request, denial, w7	2,221
440	CAWR & CAWR Penalty code 549	2,155
410	Multiple/Scrambled SSN	2,098
740	Unable to pay	2,033
750	Installment Agreements (defaulted, requests, & denials)	1,970
470	EITC Issues-other than RPS	1,918
	Grand Total	**196,040**

TABLE 1
COLLECTION DUE PROCESS

Name	Citation	Court	Issue(s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business) Note: If sufficient information to identify the issue was not available in the court case, it was placed in this category.					
Ahee	90 A.F.T.R2d (RIA) 5983 (D. Nev. 2002)	U.S. District Court	Levy	Yes	IRS
Allington	91 A.F.T.R.2d (RIA) 1825 (D. Kan. 2003)	U.S. District Court	Lien	Yes	Dismissed
Armstrong	T.C. Memo. 2002-224	U.S. Tax Court	Levy	Yes	IRS
Ashley	T.C. Memo. 2002-286	U.S. Tax Court	Lien and Levy	Yes	IRS
Aston	T.C. Memo. 2003-128	U.S. Tax Court	Lien and Levy	Yes	Split Decision
Barasch	91 A.F.T.R.2d (RIA) 1405 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Lien and Levy	Yes	IRS
Bartschi	T.C. Memo. 2002-268	U.S. Tax Court	Levy	Yes	IRS
Bentley	2002-2 U.S.T.C (CCH) P50, 751 (N.D. Ohio 2002)	U.S. District Court	Levy	Yes	Dismissed
Blair	T.C. Memo. 2002-189	U.S. Tax Court	Levy	Yes	IRS
Blanchard	90 A.F.T.R.2d (RIA) 6640 (D. Nev. 2002)	U.S. District Court	Levy	Yes	Dismissed
Bourbeau	T.C. Memo. 2003-117	U.S. Tax Court	Lien and Levy	Yes	IRS
Brandon	T.C. Summ Op 2003-34	U.S. Tax Court	Levy	Yes	IRS
Brown	T.C. Memo. 2003-73	U.S. Tax Court	Levy	Yes	IRS
Brown	90 A.F.T.R.2d (RIA) 6644 (D. Nev. 2002)	U.S. District Court	Levy	Yes	IRS
Bullock	T.C. Memo. 2003-5	U.S. Tax Court	Levy	Yes	Dismissed
Burton	T.C. Memo. 2003-116	U.S. Tax Court	Lien and Levy	Yes	IRS

APPENDIX

TABLE 1
COLLECTION DUE PROCESS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Call	91 A.F.T.R.2d (RIA) 1425 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Lien and Levy	Yes	IRS
Carrillo	91 A.F.T.R.2d (RIA) 1608 (D. Nev.), aff'd, 92 A.F.T.R.2d (RIA) 5917 (9th Cir. 2003)	U.S. District Court	Levy	Yes	IRS
Cole	90 A.F.T.R.2d (RIA) 6987 (W.D. Mich. 2002)	U.S. District Court	Levy	Yes	IRS
Copeland	T.C. Memo. 2003-46	U.S. Tax Court	Levy	Yes	IRS
Cortes	90 A.F.T.R.2d (RIA) 5629 (D. Nev. 2002)	U.S. District Court	Levy	Yes	Dismissed
Cortes	T.C. Memo. 2003-80	U.S. Tax Court	Levy	Yes	IRS
Crow	T.C. Memo. 2002-149	U.S. Tax Court	Levy	Yes	IRS
Davich	T.C. Memo. 2002-255	U.S. Tax Court	Levy	Yes	IRS
Davidson	T.C. Memo. 2002-194	U.S. Tax Court	Levy	Yes	IRS
Davidson	90 A.F.T.R.2d (RIA) 6655 (D. Nev. 2002)	U.S. District Court	Lien	Yes	IRS
Dean	90 A.F.T.R.2d (RIA) 7111 (N.D. Fla. 2002)	U.S. District Court	Levy	Yes	IRS
Dorn	119 T.C. 356 (2002)	U.S. Tax Court	Levy	No	IRS
Duncan	T.C. Memo. 2003-89	U.S. Tax Court	Lien and Levy	Yes	IRS
Eiselstein	T.C. Memo. 2003-22	U.S. Tax Court	Lien	Yes	IRS
Elek	T.C. Memo. 2003-108	U.S. Tax Court	Levy	Yes	IRS
Eliason	T.C. Memo. 2002-227	U.S. Tax Court	Levy	Yes	IRS
Elmore	T.C. Memo. 2003-123	U.S. Tax Court	Lien and Levy	Yes	IRS

TABLE 1
COLLECTION DUE PROCESS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Everman	T.C. Memo. 2003-137	U.S. Tax Court	Levy	No	Dismissed
Fabricius	90 A.F.T.R.2d (RIA) 7121 (E.D. Cal. 2002)	U.S. District Court	Levy	Yes	Dismissed
Filson	90 A.F.T.R.2d (RIA) 6399 (W.D. Tex. 2002)	U.S. District Court	Levy	Yes	IRS
Fink	T.C. Memo. 2003-61	U.S. Tax Court	Levy	Yes	IRS
Flathers	T.C. Memo. 2003-60	U.S. Tax Court	Lien	Yes	IRS
Gifford	90 A.F.T.R.2d (RIA) 7515 (D. Nev. 2002)	U.S. District Court	Lien	Yes	Dismissed
Gillett	233 F. Supp. 2d 874 (W.D. Mich. 2002)	U.S. District Court	Levy	Yes	Dismissed
Goltz	90 A.F.T.R.2d (RIA) 5991 (W.D. Tex. 2002), aff'd, 2003 U.S. App. LEXIS 20832 (5th Cir. 2003)	U.S. District Court	Lien and Levy	Yes	IRS
Gougler	T.C. Memo. 2002-185	U.S. Tax Court	Levy	Yes	IRS
Green	T.C. Memo. 2003-7	U.S. Tax Court	Lien	Yes	IRS
Gregory	91 A.F.T.R.2d (RIA) 871 (N.D. Ga. 2003)	U.S. District Court	Levy	Yes	Dismissed
Gunselman	T.C. Memo. 2003-11	U.S. Tax Court	Lien and Levy	Yes	IRS
Haas	90 A.F.T.R.2d (RIA) 5994 (D. Nev. 2002)	U.S. District Court	Levy	Yes	Dismissed
Hack	T.C. Memo. 2002-243	U.S. Tax Court	Levy	Yes	IRS
Hack	T.C. Memo. 2002-244	U.S. Tax Court	Levy	Yes	IRS
Haines	T.C. Memo. 2003-16	U.S. Tax Court	Levy	Yes	IRS
Hall	T.C. Memo. 2002-267	U.S. Tax Court	Lien	Yes	IRS

TABLE 1
COLLECTION DUE PROCESS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Harrison	90 A.F.T.R.2d (RIA) 6686 (D. Nev. 2002)	U.S. District Court	Lien	Yes	IRS
Hauck	91 A.F.T.R.2d (RIA) 2197 (6th Cir. 2003)	U.S. Court of Appeals 6th Circuit	Levy	Yes	IRS
Hempel	2002 U.S. Dist. LEXIS 19043 (W.D. Wash. 2002)	U.S. District Court	Levy	Yes	IRS
Herip	90 A.F.T.R.2d (RIA) 5770 (N.D. Ohio 2002)	U.S. District Court	Levy	Yes	Dismissed
Hickey	T.C. Memo. 2003-76	U.S. Tax Court	Lien and Levy	Yes	Split Decision
Hill	T.C. Memo. 2002-272	U.S. Tax Court	Lien and Levy	Yes	IRS
Hodgson	T.C. Memo. 2003-122	U.S. Tax Court	Lien	Yes	IRS
Holguin	T.C. Memo. 2003-125	U.S. Tax Court	Levy	Yes	IRS
Holliday	91 A.F.T.R.2d (RIA) 1338 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Lien	Yes	IRS
Johnson	2003-1 U.S.T.C. (CCH) P50, 297 (N.D. Fla. 2002)	U.S. District Court	Levy	Yes	IRS
Johnson	90 A.F.T.R.2d (RIA) 7607 (D. Nev. 2002)	U.S. District Court	Lien	Yes	Dismissed
Jombo	T.C. Memo. 2003-20	U.S. Tax Court	Lien	Yes	IRS
Jones	T.C. Memo. 2003-29	U.S. Tax Court	Lien and Levy	Yes	Dismissed
Kahre	91 A.F.T.R.2d (RIA) 1886 (D. Nev. 2003)	U.S. District Court	Lien	Yes	Dismissed
Kazunas	T.C. Memo. 2002-188	U.S. Tax Court	Lien	Yes	IRS
Keene	T.C. Memo. 2002-277	U.S. Tax Court	Levy	Yes	IRS

TABLE 1
COLLECTION DUE PROCESS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Keown	T.C. Memo. 2003-69	U.S. Tax Court	Levy	Yes	IRS
Kiley	T.C. Memo. 2002-315	U.S. Tax Court	Levy	Yes	IRS
Koenig	T.C. Memo. 2003-40	U.S. Tax Court	Lien	Yes	IRS
Land	T.C. Memo. 2002-263	U.S. Tax Court	Levy	Yes	IRS
Lemieux	90 A.F.T.R.2d (RIA) 6661 (D. Nev. 2002)	U.S. District Court	Lien	Yes	IRS
Lindner	90 A.F.T.R.2d (RIA) 7545 (E.D. Mo. 2002)	U.S. District Court	Levy	No	Dismissed
Lindsay	91 A.F.T.R.2d (RIA) 951 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Lien	Yes	IRS
Lindsey	91 A.F.T.R.2d (RIA) 953 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Lien and Levy	Yes	IRS
Lister	T.C. Memo. 2003-17	U.S. Tax Court	Levy	Yes	Split Decision
Londono	T.C. Memo. 2003-99	U.S. Tax Court	Levy	No	IRS
Loze	91 A.F.T.R.2d (RIA) 1130 (E.D. La. 2003)	U.S. District Court	Levy	Yes	IRS
Lyman	T.C. Memo. 2003-72	U.S. Tax Court	Lien and Levy	Yes	IRS
Martinec	90 A.F.T.R.2d (RIA) 5678 (D. Nev. 2002)	U.S. District Court	Levy	Yes	Dismissed
McCandless	90 A.F.T.R.2d (RIA) 7181 (N.D. Cal. 2002)	U.S. District Court	Levy	Yes	Dismissed
Merriweather	T.C. Memo. 2002-226	U.S. Tax Court	Levy	Yes	IRS
Michael	T.C. Memo. 2003-26	U.S. Tax Court	Levy	Yes	IRS
Mitchell	90 A.F.T.R.2d (RIA) 5684 (D. Nev. 2002)	U.S. District Court	Lien and Levy	Yes	Dismissed

APPENDIX

TABLE 1
COLLECTION DUE PROCESS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Monk	90 A.F.T.R.2d (RIA) 5724 (D. Nev. 2002)	U.S. District Court	Lien	Yes	Dismissed
Moore	T.C. Memo. 2003-1	U.S. Tax Court	Lien	Yes	IRS
Morgan	90 A.F.T.R.2d (RIA) 5725 (D. Nev. 2002)	U.S. District Court	Levy	Yes	Dismissed
Morgan	T.C. Memo. 2002-210	U.S. Tax Court	Levy	No	IRS
Moses	90 A.F.T.R.2d (RIA) 5726 (D. Nev. 2002)	U.S. District Court	Levy	Yes	IRS
Mudd	T.C. Memo. 2002-204	U.S. Tax Court	Levy	Yes	IRS
Nebres	T.C. Memo. 2003-102	U.S. Tax Court	Levy	Yes	IRS
Needham	90 A.F.T.R.2d (RIA) 5260 (D. Nev. 2002)	U.S. District Court	Levy	Yes	IRS
Nelson	T.C. Memo. 2002-264	U.S. Tax Court	Lien and Levy	Yes	Dismissed
Nestor	T.C. Memo. 2002-251	U.S. Tax Court	Levy	Yes	IRS
Nichols	T.C. Memo. 2002-317	U.S. Tax Court	Lien and Levy	Yes	IRS
Olson	90 A.F.T.R.2d (RIA) 5669 (D. Ariz. 2002)	U.S. District Court	Levy	Yes	Dismissed
Orr	T.C. Memo. 2003-141	U.S. Tax Court	Levy	Yes	IRS
Perez	T.C. Memo. 2002-274	U.S. Tax Court	Levy	Yes	IRS
Perry	T.C. Memo. 2002-165	U.S. Tax Court	Levy	Yes	IRS
Pesci	91 A.F.T.R.2d (RIA) 2341 (D. Nev. 2003)	U.S. District Court	Lien and Levy	Yes	Dismissed
Porter	91 A.F.T.R.2d (RIA) 946 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Lien and Levy	Yes	IRS

TABLE 1
COLLECTION DUE PROCESS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Raft	2003-1 U.S.T.C. (CCH) P 50,435 (N.D. Ohio 2003)	U.S. District Court	Levy	No	Dismissed
Raymond	119 T.C. 191 (2002)	U.S. Tax Court	Lien and Levy	Yes	IRS
Rennie	216 F. Supp. 2d 1078 (E.D. Cal. 2002)	U.S. District Court	Levy	Yes	Dismissed
Rennie	T.C. Memo. 2002-296	U.S. Tax Court	Levy	Yes	IRS
Reynoso	90 A.F.T.R.2d (RIA) 7079 (D. Nev. 2002)	U.S. District Court	Levy	Yes	IRS
Richardson	T.C. Memo. 2003-154	U.S. Tax Court	Lien	Yes	IRS
Rivera	T.C. Memo. 2003-35	U.S. Tax Court	Lien	Yes	Split Decision
Roberts	90 A.F.T.R.2d (RIA) 5276 (D. Nev. 2002)	U.S. District Court	Levy	Yes	Dismissed
Robinson	T.C. Memo. 2002-316, aff'd, 92 A.F.T.R.2d (RIA) 5968 (4th Cir. 2003)	U.S. Tax Court	Levy	Yes	IRS
Robinson	T.C. Memo. 2003-77	U.S. Tax Court	Levy	Yes	IRS
Robison	90 A.F.T.R.2d (RIA) 6004 (D. Nev. 2002)	U.S. District Court	Levy	Yes	Dismissed
Roeder	91 A.F.T.R.2d (RIA) 886 (S.D. Fla.)	U.S. District Court	Levy	Yes	Dismissed
Sager	90 A.F.T.R.2d (RIA) 7083 (W.D. Pa. 2002)	U.S. District Court	Levy	Yes	Dismissed
Samlaska	90 A.F.T.R.2d (RIA) 6723 (D. Nev. 2002)	U.S. District Court	Levy	Yes	IRS
Schake	T.C. Memo. 2002-262	U.S. Tax Court	Lien	Yes	Dismissed
Schaper	T.C. Memo. 2002-203	U.S. Tax Court	Levy	Yes	IRS
Schenkel	T.C. Memo. 2003-37	U.S. Tax Court	Lien	Yes	IRS

TABLE 1
COLLECTION DUE PROCESS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Schmith	T.C. Memo. 2002-252	U.S. Tax Court	Levy	Yes	IRS
Schnitzler	T.C. Memo. 2002-159	U.S. Tax Court	Levy	Yes	IRS
Schrems	T.C. Memo. 2003-25	U.S. Tax Court	Lien	Yes	IRS
Shaffer	91 A.F.T.R.2d (RIA) 842 (10th Cir. 2003)	U.S. Court of Appeals 10th Circuit	Levy	Yes	IRS
Silver	90 A.F.T.R.2d (RIA) 6575 (W.D.N.Y. 2002)	U.S. District Court	Lien	Yes	Split Decision
Smith	250 F. Supp.2d 1266 (D. Ore. 2003)	U.S. District Court	Lien and Levy	Yes	Dismissed
Smith	90 A.F.T.R.2d (RIA) 6748 (D. Nev. 2002)	U.S. District Court	Levy	Yes	IRS
Smith	T.C. Memo. 2002-304	U.S. Tax Court	Levy	Yes	IRS
Smith	T.C. Memo. 2003-45	U.S. Tax Court	Levy	Yes	IRS
Sponberg	T.C. Memo. 2002-177	U.S. Tax Court	Levy	Yes	IRS
Standifird	T.C. Memo. 2002-245, aff'd, 92 A.F.T.R.2d (RIA) 5936 (9th Cir. 2003)	U.S. Tax Court	Levy	Yes	IRS
Stanley	90 A.F.T.R2d (RIA) 7536 (D. Nev. 2002)	U.S. District Court	Lien	Yes	Dismissed
Stark	T.C. Memo. 2003-47	U.S. Tax Court	Levy	Yes	IRS
Steidel	90 A.F.T.R.2d (RIA) 5705 (W.D. Wash. 2002) aff'd, 91 A.F.T.R.2d 922 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Lien and Levy	Yes	Dismissed
Stewart	T.C. Memo. 2002-225	U.S. Tax Court	Levy	Yes	IRS
Stoewer	T.C. Memo. 2002-167	U.S. Tax Court	Lien	Yes	Dismissed

TABLE 1
COLLECTION DUE PROCESS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Stoewer	T.C. Memo. 2003-71	U.S. Tax Court	Lien	Yes	IRS
Swann	T.C. Memo. 2003-70	U.S. Tax Court	Levy	Yes	IRS
Tapio	T.C. Memo. 2002-141	U.S. Tax Court	Levy	Yes	IRS
Tatum	T.C. Memo. 2003-115	U.S. Tax Court	Levy	No	Remanded
Tilley	T.C. Memo. 2002-161	U.S. Tax Court	Levy	No	Dismissed
Tornichio	T.C. Memo. 2002-291	U.S. Tax Court	Levy	Yes	IRS
Tornichio	263 F. Supp. 2d 1090 (N.D. Ohio 2002)	U.S. District Court	Levy	Yes	Dismissed
Tschida	91 A.F.T.R.2d (RIA) 1272 (8th Cir. 2003)	U.S. Court of Appeals 8th Circuit	Lien and Levy	Yes	IRS
Uveges	90 A.F.T.R.2d (RIA) 6764 (D. Nev. 2002)	U.S. District Court	Lien	Yes	IRS
Villwock	T.C. Memo. 2002-235	U.S. Tax Court	Levy	Yes	IRS
Voorhees	T.C. Memo. 2002-289	U.S. Tax Court	Levy	Yes	Dismissed
Wagner	T.C. Memo. 2002-180	U.S. Tax Court	Lien and Levy	Yes	IRS
Wagner	90 A.F.T.R.2d (RIA) 6768 (D. Nev. 2002)	U.S. District Court	Levy	Yes	Dismissed
Waller	90 A.F.T.R.2d (RIA) 6759 (D. Nev. 2002)	U.S. District Court	Levy	Yes	IRS
Washington	120 T.C. 114 (2003)	U.S. Tax Court	Lien	Yes	IRS
Wasson	91 A.F.T.R.2d (RIA) 1416 (6th Cir. 2003)	U.S. Court of Appeals 6th Circuit	Lien and Levy	Yes	IRS
Weishan	91 A.F.T.R.2d (RIA) 2332 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Lien and Levy	No	IRS

TABLE 1

COLLECTION DUE PROCESS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Wheelis	91 A.F.T.R.2d (RIA) 1655 (D. Ariz. 2003)	U.S. District Court	Levy	Yes	IRS
White	250 F. Supp. 2d 919 (M.D. Tenn. 2003)	U.S. District Court	Levy	Yes	Dismissed
Widner	T.C. Memo. 2003-114	U.S. Tax Court	Levy	Yes	IRS
Williams	T.C. Memo. 2003-83	U.S. Tax Court	Levy	Yes	IRS
Wilson	T.C. Memo. 2002-242	U.S. Tax Court	Levy	Yes	Split Decision
Wooten	T.C. Memo. 2003-113	U.S. Tax Court	Lien and Levy	Yes	IRS
Young	T.C. Memo. 2003-6	U.S. Tax Court	Lien	Yes	IRS
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)					
Anderson	T.C. Memo. 2003-112	U.S. Tax Court	Levy	Yes	IRS
Beery	T.C. Memo. 2003-38	U.S. Tax Court	Levy	Yes	Dismissed
Behling	118 T.C. 572 (2002)	U.S. Tax Court	Lien	Yes	IRS
Cardinal Healthcare, Inc.	90 A.F.T.R.2d (RIA) 5782 (S.D. Ill. 2002)	U.S. District Court	Levy	No	IRS
Carey	T.C.Memo. 2002-209	U.S. Tax Court	Lien and Levy	Yes	IRS
Carlson	2003-1 U.S. Tax Cas. (CCH) P50, 265 (S.D. Iowa 2003)	U.S. District Court	Levy	No	IRS
Cmty Residential Servs., Inc.	91 A.F.T.R.2d (RIA) 2190 (M.D.N.C 2003)	U.S. District Court	Levy	No	IRS
Craig	119 T.C. 252 (2002)	U.S. Tax Court	Levy	Yes	IRS

TABLE 1
COLLECTION DUE PROCESS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Dudley's Comm. & Indus. Coating, Inc.	91 A.F.T.R.2d (RIA) 1779 (M.D. Tenn. 2003)	U.S. District Court	Levy	No	IRS
Eubanks	T.C. Summ. Op. 2003-31	U.S. Tax Court	Lien	Yes	IRS
Frank	T.C. Memo. 2003-88	U.S. Tax Court	Levy	Yes	IRS
Guy	90 A.F.T.R.2d (RIA) 5462 (E.D.N.Y. 2002)	U.S. District Court	Levy	No	Dismissed
Harmornick	T.C. Memo. 2002-219	U.S. Tax Court	Levy	Yes	IRS
Hochschild	T.C. Memo. 2002-195	U.S. Tax Court	Levy	Yes	IRS
Hoffman	119 T.C. 140 (2002)	U.S. Tax Court	Lien and Levy	No	Taxpayer
Horejs	T.C. Memo. 2002-240	U.S. Tax Court	Lien	Yes	IRS
Horejs	T.C. Memo. 2002-241	U.S. Tax Court	Lien	Yes	IRS
Horn	T.C. Memo. 2002-207	U.S. Tax Court	Levy	Yes	IRS
Hyler	T.C. Memo. 2002-321	U.S. Tax Court	Lien and Levy	Yes	IRS
Kaye	T.C. Memo. 2003-74	U.S. Tax Court	Levy	Yes	IRS
Kingsway Servs., LLC	2003 U.S. Dist. LEXIS 2264 (M.D. Tenn. 2003)	U.S. District Court	Levy	No	IRS
Lee	T.C. Memo. 2002-233, aff'd, 92 AFTR2d (RIA) 5686 (9th Cir. 2003)	U.S. Tax Court	Levy	Yes	IRS
Maloney	T.C. Memo. 2003-143	U.S. Tax Court	Levy	Yes	IRS
Maton	91 A.F.T.R.2d (RIA) 1809 (N.D. Ill. 2003)	U.S. District Court	Levy	No	Dismissed
McCorkle	T.C. Memo. 2003-34	U.S. Tax Court	Levy	No	IRS

APPENDIX

TABLE 1
COLLECTION DUE PROCESS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Milnes	T.C. Memo. 2003-62	U.S. Tax Court	Lien and Levy	Yes	IRS
Muldavin	T.C. Memo. 2002-182	U.S. Tax Court	Lien	Yes	IRS
Myers	91 A.F.T.R.2d (RIA) 1933 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Lien and Levy	Yes	IRS
Pelliccio	253 F. Supp. 2d 258 (D. Conn. 2003)	U.S. District Court	Lien and Levy	No	IRS
Pride	T.C. Memo. 2002-2085	U.S. Tax Court	Lien	Yes	IRS
Roberts	T.C. Memo. 2002-221	U.S. Tax Court	Levy	Yes	IRS
Rodriguez	T.C. Memo. 2003-153	U.S. Tax Court	Levy	Yes	IRS
Schroeder	T.C. Memo. 2002-190	U.S. Tax Court	Levy	Yes	IRS
Smeton	T.C. Memo. 2002-140	U.S. Tax Court	Levy	Yes	IRS
Stewart	91 A.F.T.R.2d (RIA) 434 (W.D. Pa. 2002)	U.S. District Court	Levy	Yes	IRS
Stop 26-Riverbend Inc.	91 A.F.T.R.2d (RIA) 1688 (S.D. Ohio 2003)	U.S. District Court	Lien and Levy	No	IRS
Tabak	T.C. Memo. 2003-4	U.S. Tax Court	Lien	Yes	IRS
Triad Microsystems Inc.	90 A.F.T.R.2d (RIA) 7332 (E.D. Va. 2002)	U.S. District Court	Levy	No	IRS
Summers	254 F.Supp. 2d 589 (E.D. Pa. 2003)	U.S. District Court	Lien and Levy	No	Dismissed
Walker	90 A.F.T.R.2d (RIA) 6770 (S.D. Cal. 2002)	U.S. District Court	Levy	No	Dismissed
Wodarczyk	T.C. Summ. Op. 2002-123	U.S. Tax Court	Levy	No	IRS
Wright	T.C. Memo. 2002-312	U.S. Tax Court	Levy	Yes	IRS

TABLE 2
INCOME ISSUES

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Individual Taxpayers (Issues other than Business)					
Ancira	119 T.C. 135 (2002)	U.S. Tax Court	Pension Income	No	Taxpayer
Ashley	T.C. Memo. 2002-286	U.S. Tax Court	Unreported Income	Yes	IRS
Aston	T.C. Memo. 2003-104	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Baldwin	T.C. Memo. 2002-162	U.S. Tax Court	Rental Income	No	IRS
Bannister	90 A.F.T.R.2d. (RIA) 6550 (W.D. Wis. 2002)	U.S. District Court	Commission Income	No	IRS
Beeson	U.S. Dist. LEXIS 18239 (D. Del. 2002)	U.S. District Court	Dividend Income	No	IRS
Bell	238 F. Supp. 2d. 696 (M.D. Pa. 2003)	U.S. District Court	Compensation for Services /Frivolous	Yes	IRS
Beneventi	T.C. Summ. Op. 2003-13	U.S. Tax Court	Pension Income	Yes	IRS
Berardi	92 A.F.T.R.2d (RIA) 5669 (3rd Cir. 2003)	U.S. Court of Appeals 3rd Circuit	Gambling Income	No	IRS
Boler	T.C. Memo. 2002-155	U.S. Tax Court	Dividend Income	No	IRS
Bourbeau	T.C. Memo. 2003-117	U.S. Tax Court	Compensation for Services/ Frivolous	Yes	IRS
Bowers	T.C. Summ. Op. 2003-57	U.S. Tax Court	Debt Cancellation	No	IRS
Brooks	276 F. Supp. 2d 653 (E.D. Ky. 2003)	U.S. District Court	Settlement Income	No	IRS
Burnett	T.C. Memo. 2002-181 aff'd, 91 A.F.T.R.2d (RIA) 2376 (5th Cir. 2003)	U.S. Tax Court	Unreported Income	Yes	IRS

TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Byrne	T.C. Memo. 2002-319	U.S. Tax Court	Disability Income	No	Taxpayer
Cabirac	120 T.C. 163 (2003)	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Carey	T.C. Memo. 2002-209	U.S. Tax Court	Interest Income	Yes	IRS
Chin	T.C. Memo. 2003-30	U.S. Tax Court	Rental Income	No	IRS
Choi	T.C. Memo. 2002-183	U.S. Tax Court	Unreported Income	No	IRS
Christians	T.C. Memo. 2003-130	U.S. Tax Court	Underreported Income	No	IRS
Cisneros	T.C. Summ. Op. 2002-73	U.S. Tax Court	Gambling Income	Yes	IRS
Clendenen	T.C. Memo. 2003-32, aff'd, 345 F.3d 568 (8th Cir. 2003)	U.S. Tax Court	Interest Income	No	IRS
Cohen	T.C. Memo. 2003-42	U.S. Tax Court	Underreported Income	No	IRS
Cortes	T.C. Memo. 2003-80	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Crow	T.C. Memo. 2002-149	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Davich	T.C. Memo. 2002-255	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Davidson	T.C. Memo. 2002-194	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
DePaoli	90 A.F.T.R.2d (RIA) 5416 (3d. Cir. 2002)	U.S. Court of Appeals 3rd Circuit	Dividend Income	No	IRS
Dezagottis	T.C. Summ. Op. 2002-122	U.S. Tax Court	Unreported Income	Yes	IRS

TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Donohoe	T.C. Summ. Op. 2002-136	U.S. Tax Court	Compensation for Services	Yes	IRS
Downing	2002-2 U.S.T.C. (CCH) P50661 (N.D. Iowa 2002), a'ffd, 2003-1 U.S.T.C. (CCH) P50466 (8th Cir. 2003)	U.S. District Court	Unreported Income	Yes	IRS
Duncan	T.C. Memo. 2003-89	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Earnshaw	T.C. Memo. 2002-191	U.S. Tax Court	Debt Cancellation	Yes	IRS
Eiselstein	T.C. Memo. 2003-22	U.S. Tax Court	Compensation for Services	Yes	IRS
Emerson	T.C. Memo. 2003-82	U.S. Tax Court	Settlement Income	No	Split Decision
Evanko	T.C. Summ. Op. 2002-114	U.S. Tax Court	Pension Income	Yes	IRS
Fields	T.C. Memo. 2002-320	U.S. Tax Court	Underreported Income	No	IRS
Forste	T.C. Memo. 2003-103	U.S. Tax Court	Disability /Settlement Income	No	Split Decision
Fowler	T.C. Memo. 2002-223	U.S. Tax Court	Rental Income	No	IRS
Francisco	119 T.C. 317 (2002)	U.S. District Court	Compensation for Services	Yes	IRS
Frank	T.C. Memo. 2003-88	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Getman	T.C. Summ. Op. 2002-121	U.S. Tax Court	Compensation for Services	Yes	IRS
Gill	T.C. Memo. 2002-146	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS

TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Gomez	91 A.F.T.R.2d (RIA) 2276 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Compensation for Services /Frivolous	Yes	IRS
Hambarian	118 T.C. 565 (2002)	U.S. Tax Court	Underreported Income	No	IRS
Han	T.C. Memo. 2002-148	U.S. Tax Court	Dividend Income	No	IRS
Harmornick	T.C. Memo. 2002-219	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Hart	324 F.3d 575 (8th Cir. 2003)	U.S. Court of Appeals 8th Circuit	Commission Income	Yes	IRS
Hartz	T.C. Summ. Op. 2003-25	U.S. Tax Court	Compensation for Services	No	IRS
Helm	T.C. Summ. Op. 2002-138	U.S. Tax Court	Pension Income	Yes	IRS
Hill	T.C. Memo. 2003-144	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Hoffman	119 T.C. 140 (2002)	U.S. Tax Court	Rental Income	No	Taxpayer
Holguin	T.C. Memo. 2003- 125	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Huffine	2003 U.S. Dist. LEXIS 583 (E.D. La. 2003)	U.S. District Court	Underreported Income	No	IRS
Isaac	T.C. Summ. Op. 2002-111	U.S. Tax Court	Capital Gains Income	Yes	IRS
Johnson	2003-1 U.S.T.C. (CCH) P 50297 (N.D. Fla. 2002)	U.S. District Court	Compensation for Services /Frivolous	Yes	IRS
Jombo	T.C. Memo. 2002-273	U.S. Tax Court	Compensation for Services	Yes	IRS
Jones	T.C. Memo. 2003-14	U.S. Tax Court	Compensation for Services	No	IRS

TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Jones	T.C. Memo. 2003-131	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Joseph	T.C. Memo. 2003-19	U.S. Tax Court	Unreported Income	Yes	IRS
Keene	T.C. Memo. 2002-277	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Keown	T.C. Memo. 2003-69	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Kinslow	T.C. Memo. 2002-313	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Koehn	91 A.F.T.R. 2d. (RIA) 1318 (E.D. Mich. 2003)	U.S. District Court	Interest Income	Yes	IRS
Land	T.C. Memo 2002-263	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Langer	91 A.F.T.R. 2d (RIA) 1738 (D. Minn. 2003)	U.S. District Court	Rental Income	Yes	Taxpayer
Mills	T.C. Summ. Op. 2003-41	U.S. Tax Court	Pension Income	Yes	IRS
Laws	T.C. Memo. 2003-21	U.S. Tax Court	Pension income	Yes	IRS
Leppin	T.C. Summ. Op. 2002-143	U.S. Tax Court	Pension Income	Yes	IRS
Lyman	T.C. Memo. 2003-72	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Mantakounis	T.C. Memo. 2002-306	U.S. Tax Court	Unreported Income	No	IRS
Maxie	T.C. Summ. Op. 2002-113	U.S. Tax Court	Unreported Income	Yes	IRS
McCandless	90 A.F.T.R.2d (RIA) 7181 (N.D. Cal. 2002)	U.S. District Court	Compensation for Services	Yes	IRS

TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Middleton	T.C. Memo. 2002-164	U.S. Tax Court	Unreported Income	Yes	IRS
Mihok	T.C. Summ. Op. 2002-157	U.S. Tax Court	Pension Income	Yes	IRS
Miley	T.C. Memo. 2002-236	U.S. Tax Court	Disability Income	Yes	IRS
Miller	T.C. Summ. Op. 2002-94	U.S. Tax Court	Settlement Income	No	Taxpayer
Monroe	T.C. Summ. Op. 2002-79	U.S. Tax Court	Rental Income	Yes	IRS
Montgomery	T.C. Memo. 2003-64	U.S. Tax Court	Settlement Income	No	IRS
Morganstein	T.C. Summ. Op. 2002-96	U.S. Tax Court	Compensation for Services	No	IRS
Newell	T.C. Summ. Op. 2003-1	U.S. Tax Court	Alimony Income	No	Taxpayer
Neymeyer	T.C. Summ. Op. 2002-120	U.S. Tax Court	Gambling Income.	Yes	IRS
Ngosso	T.C. Summ. Op. 2002-154	U.S. Tax Court	Unreported Income	No	IRS
Nicholas	T.C. Summ. Op. 2002-77	U.S. Tax Court	Pension Income	Yes	IRS
Noble	T.C. Summ. Op. 2002-68	U.S. Tax Court	Dividend Income	Yes	IRS
O'Toole	T.C. Memo. 2002-265	U.S. Tax Court	Unreported Income	Yes	IRS
Fatta	T.C. Summ. Op. 2002-99	U.S. Tax Court	Dividend Income	Yes	IRS
Palermino	T.C. Summ. Op. 2003- 45	U.S. Tax Court	Pension Income	Yes	IRS
Palmer	T.C. Summ. Op. 2003-5	U.S. Tax Court	Pension Income	Yes	IRS
Paz	T.C. Memo. 2002-220	U.S. Tax Court	Gambling Income	No	IRS
Perry	T.C. Memo. 2002-165	U.S. Tax Court	Compensation for services /Frivolous	Yes	IRS

TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Pfister	T.C. Memo. 2002-198	U.S. Tax Court	Alimony Income	No	IRS
Porter	T.C. Summ. Op. 2003-14	U.S. Tax Court	Settlement Income	Yes	IRS
Prasil	T.C. Memo. 2003-100	U.S. Tax Court	Settlement Income	Yes	IRS
Rauenhoust	119 T.C. 157 (2002)	U.S. Tax Court	Dividend Income	No	IRS
Raymond	247 F. Supp 2d. 548 (D. Vt. 2002)	U.S. District Court	Settlement Income	No	Taxpayer
Rennie	216 F. Supp. 2d 1078 (E.D. Cal. 2002)	U.S. District Court	Compensation for Services /Frivolous	Yes	IRS
Reynolds	296 F.3d 607 (7th Cir. 2002)	U.S. Tax Court	Rental Income	No	IRS
Rhodis	91 A.F.T.R.2d (RIA) 551 (2d Cir. 2003)	U.S. Court of Appeals 2nd Circuit	Rental Income	No	IRS
Rhodis	91 A.F.T.R.2d (RIA) 548 (2d Cir. 2003)	U.S. Court of Appeals 2nd Circuit	Rental Income	No	IRS
Roberts	T.C. Memo. 2002-281	U.S. Tax Court	Pension Income	Yes	IRS
Sandalis	2002-2 U.S.T.C. (CCH) P 50516 (4th Cir. 2002)	U.S. Court of Appeals 4th Circuit	Dividend Income	No	IRS
Saunders	T.C. Memo. 2002-143	U.S. Tax Court	Rental Income	Yes	IRS
Sawukaytis	T.C. Memo. 2002-156	U.S. Tax Court	Compensation for Services /Frivolous.	Yes	IRS
Scallen	T.C. Memo. 2002-294	U.S. Tax Court	Interest Income	No	IRS
Schaper	TC. Memo. 2002-203	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS

TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Schmith	T.C. Memo. 2002-252	U.S. Tax Court	Compensation for Services /Frivolous.	Yes	IRS
Schnitzler	T.C. Memo. 2002-159	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Schroeder	T.C. Memo. 2002-190	U.S. Tax Court	Compensation for Services	Yes	IRS
Schroeder	T.C. Memo. 2002-211	U.S. Tax Court	Rental Income	Yes	IRS
Seggerman	308 F.3d 803 (7th Cir. 2002)	U.S. Court of Appeals 7th Circuit	Capital Gain Income	No	IRS
Shaw	T.C. Memo. 2003-111	U.S. Tax Court	Underreported Income	No	IRS
Sims	T.C. Summ. Op. 2002-76	U.S. Tax Court	Debt Cancellation	Yes	Taxpayer
Smeton	T.C. Memo. 2002-140	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Smith	T.C. Summ. Op. 2003-28	U.S. Tax Court	Unreported Income	Yes	IRS
Spurlock	T.C. Memo. 2003-124	U.S. Tax Court	Compensation for Services	Yes	IRS
Standifird	T.C. Memo. 2002-245, aff'd, 92 A.F.T.R.2d. (RIA) 5936 (9th Cir. 2003)	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Steffen	T.C. Memo. 2002-229	U.S. Tax Court	Capital Gain Income	No	IRS
Stewart	T.C. Memo. 2002-199	U.S. Tax Court	Compensation for services	No	IRS
Stoewer	T.C. Memo. 2003-71	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Strong	T.C. Memo. 2003-87	U.S. Tax Court	Underreported Income	No	IRS

TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Summers	254 F. Supp 2d 589 (E.D. Pa. 2003)	U.S. District Court	Commission Income.	No	IRS
Swann	T.C. Memo. 2003-70	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Takaba	119 T.C. 285 (2002)	U.S. Tax Court	Compensation for Services /Frivolous	No	IRS
Tapio	T.C. Memo. 2002-141	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Thomas	90 A.F.T.R.2d (RIA) 7603 (9th Cir. 2002)	U.S. Court of Appeals 9th Circuit	Compensation for Services	Yes	IRS
Thrower	T.C. Memo. 2003-139	U.S. Tax Court	Rental Income	Yes	IRS
Toberman	294 F.3d 985 (8th Cir. 2002)	U.S. Court of Appeals 8th Circuit	Debt Cancellation	No	Split Decision
Tough	91 A.F.T.R.2d (RIA) 501 (E.D. Mich. 2002), aff'd, 92 A.F.T.R.2d (RIA) 6200 (6th Cir. 2003)	U.S. District Court	Compensation for Services /Frivolous	Yes	IRS
Tussey	T.C. Summ. Op. 2003-47	U.S. Tax Court	Pension Income	Yes	IRS
Villwock	T.C. Memo. 2002-235	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Wagner	T.C. Memo. 2002-180	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
White	T.C. Summ. Op. 2002-101	U.S. Tax Court	Unreported Income	Yes	IRS
Williams	T.C. Memo. 2003-97	U.S. Tax Court	Compensation for Services	No	IRS

TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Williams	T.C. Memo. 2003-83	U.S. Tax Court	Compensation for Services /Frivolous	Yes	IRS
Wilson	118 T.C. 537 (2002)	U.S. Tax Court	Dividend Income	No	IRS
Wilson	T.C. Memo. 2002-234	U.S. Tax Court	Compensation for Services/ Frivolous	Yes	IRS
Zinn	T.C. Summ. Op. 2002-71	U.S. Tax Court	Interest Income.	Yes	IRS
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)					
Beagles	T.C. Memo. 2003-67	U.S. Tax Court	Partnership Income	Yes	IRS
Blonien	118 T.C. 541(2002)	U.S. Tax Court	Partnership Income	No	IRS
Browning-Ferris Indus.	91 A.F.T.R.2d (RIA) 1641 (D. Ariz. 2003); 233 F. Supp. 2d 1223 (D. Ariz. 2002)	U.S. District Court	Partnership Income	No	Taxpayer
Coggin Auto Corp.	292 F.3d 1326 (11th Cir. 2002)	U.S. Court of Appeals 11th Circuit	S-Corporation Income	No	Taxpayer
Comtek Expositions, Inc.	T.C. Memo. 2003-135	U.S. Tax Court	Compensation for Services	No	IRS
Cuddeback Mem. Fund	T.C. Memo. 2002-300	U.S. Tax Court	Trust Income	No	IRS
Depasture	T.C. Summ. Op. 2003-27	U.S. Tax Court	S-Corporation Income	No	IRS

TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Field	89 A.F.T.R.2d (RIA) 2993 (S.D.N.Y. 2002), vacated & remanded, 328 F.3d. 58 (2d Cir. 2003); remand, 92 A.F.T.R.2d. (RIA) 6929 (S.D.N.Y. 2003)	U.S. District Court	Partnership Income	Yes	Remanded
Fior D'Italia	536 U.S. 238 (2002)	U.S. Supreme Court	Unreported Income	No	IRS
George	T.C. Memo. 2002-163	U.S. Tax Court	Partnership Income	Yes	IRS
Gingerich	54 Fed. Cl. 222 (2002)	U.S. Court of Federal Claims	Partnership Income	No	IRS
Hvidding	T.C. Memo. 2003-151	U.S. Tax Court	Trust Income	No	IRS
IES Industries, Inc	90 A.F.T.R.2d (RIA) 5833 (N.D. Iowa 2002), aff'd, 2003 U.S. App. LEXIS 23229 (8th Cir. 2003)	U.S. District Court	Dividend Income	No	IRS
Indeck Energy Servs., Inc.	T.C. Memo. 2003-101	U.S. Tax Court	Interest Income	No	Taxpayer
Johnson & Begole	T.C. Memo. 2002-239	U.S. Tax Court	Unreported income	No	IRS
Lindsey	T.C. Memo. 2002-278	U.S. Tax Court	Partnership Income	No	IRS
Madison Recycling Assocs.	295 F.3d 280 (2d Cir. 2002)	U.S. Court of Appeals 2nd Circuit	Partnership Income	No	IRS
Medchem, Inc	295 F.3d 118 (1st Cir. 2002)	U.S. Court of Appeals 1st Circuit	Dividend Income	No	IRS
Merrill Lynch	120 T.C. 12 (2003)	U.S. Tax Court	Capital Gain Income	No	IRS

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TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Monahan	321 F.3d. 1063 (11th Cir. 2003)	U.S. Court of Appeals 11th Circuit	Partnership Income	Yes	IRS
Neonatology Assocs. PA	299 F.3d. 221 (3d Cir. 2002)	U.S. Court of Appeals 3rd Circuit	Dividend Income	No	IRS
Noble	T.C. Summ. Op. 2002-68	U.S. Tax Court	Dividend Income	Yes	IRS
Riggs Nat'l Corp	295 F.3d 16 (D.C. Cir. 2002)	U.S. Court of Appeals D.C. Circuit	Interest Income	No	Taxpayer
Sams	T.C. Summary Opinion. 2002-95	U.S. Tax Court	S-Corporation Income	Yes	IRS
Sherwin-Williams Co Emple. Health Plan Trust, Keybank	90 A.F.T.R.2d (RIA) 6795 (N.D. Ohio 2002)	U.S. District Court	Trust Income	No	IRS
Specialty Transp & Delivery Servs.	T.C. Memo. 2003-51	U.S. Tax Court	Compensation for Services	No	IRS
Tampa Bay Devil Rays, Ltd.	T.C. Memo. 2002-248	U.S. Tax Court	Partnership Income	No	Taxpayer
TCS Auto Wholesale	90 A.F.T.R. 2d.(RIA) 5279 (E.D. Wash. 2002)	U.S. District Court	Dividend Income	No	IRS
Temple	91 A.F.T.R.2d (RIA) 1806 (6th Cir. 2003)	U.S. Court of Appeals 6th Circuit	Trust Income	No	IRS
Veterinary Surgical Consultants, P.C.	T.C. Memo. 2003-48	U.S. Tax Court	Compensation for Services	No	IRS

TABLE 2
INCOME ISSUES (CONT.)

NAME	CITATION	COURT	ISSUE (S)	PRO SE	DECISION
Water-Pure Sys	T.C. Memo. 2003-53	U.S. Tax Court	Compensation for Services	No	IRS
Estate and Gift Taxpayers					
Bailey, Estate of	T.C. Memo. 2002-152	U.S. Tax Court	Gift Income	No	Split Decision
Ballantyne Estate of	T.C. Memo. 2002-160, aff'd, 341 F.3d 802 (8th Cir. 2003)	U.S. Tax Court	Partnership Income	No	IRS
Davis, Estate of	T.C. Memo. 2003-55	U.S. Tax Court	Trust Income	No	IRS
Glover, Estate of	T.C. Memo. 2002-186	U.S. Tax Court	Estate Income	No	IRS
Helis ex rel. Henry	52 Fed. Cl. 745 (2002), vacated in part, corrected in part on reconsideration, 55 Fed. Cl. 544 (2003)	U.S. Court of Federal Claims	Estate Income	No	Taxpayer
Wells Fargo Bank N. M., NA	319 F.3d. 1222 (10th Cir. 2003)	U.S. Court of Appeals 10th Circuit	Trust Income	No	IRS

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TABLE 3
TRADE OR BUSINESS EXPENSES

Name	Citation	Court	Issue(s)	Pro Se	Decision
Business Taxpayers (Sole Proprietorships, including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)					
Bestor	T.C. Summ. Op. 2002-78	U.S. Tax Court	Schedule C Expenses §162 Car and truck expenses §274 Home Office §280A	Yes	IRS
Blankson	T. C. Summ. Op. 2003-12	U.S. Tax Court	§162, §6001, § 6662, Cohan Rule business expenses.	Yes	Split Decision
Boise Cascade Corp.	329 F.3d 751 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	§ 162 and § 404(k) Deductibility of payments to ESOP	No	Taxpayer
Boler	T. C. Memo. 2002-155	U.S. Tax Court	§162, 274, 263, 44 Bad debt, Cost of goods sold, Travel & entertainment, and Capitalized expenses	No	Split Decision
Bone	324 F.3d 1289 (11th Cir. 2003)	U.S. Court of Appeals 11th Circuit	§ 162 – Ordinary and necessary – expenses paid on behalf of another does not meet §162 requirements.	No	IRS
Butler	T.C. Memo. 2002-314	U.S. Tax Court	§162 payments as bribes, kickbacks §6662-6664 §6901 transferee liability	No	IRS
Campbell	T.C. Summ. Op. 2002-117	U.S. Tax Court	§162 v. § 263(a) – Removing and replacing the roof-covering material on residential rental house.	Yes	Taxpayer

TABLE 3
TRADE OR BUSINESS EXPENSES (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Capital Video Corp.	311 F.3d 458 (1st Cir. 2002)	U.S. Court of Appeals 1st Circuit	§ 162 Legal fees of shareholder paid by Corporation	No	IRS
Chin	T.C. Memo. 2003-30	U.S. Tax Court	§162 - Rent payments as ordinary and necessary business expenses	No	IRS
Churchill Downs, Inc.	307 F.3d 423 (6th Cir. 2002)	U.S. Court of Appeals 6th Circuit	§ 162 Entertainment expenses limited to §274	No	IRS
Cinergy Corp.	55 Fed. Cl. 489 (2003)	U.S. Court of Federal Claims	§1341 "claim of right" provision. Cost recovery of removing asbestos. Deductibility of refund of over-recovery payment received.	No	Split Decision
Devine Brothers, Inc.	T.C. Memo. 2003-15	U.S. Tax Court	§162 Reasonable compensation	No	Taxpayer
Dobbe	91 A.F.T.R.2d (RIA) 1405 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	§162 Landscaping expenses	No	IRS
Dow Chem. Co.	250 F. Supp. 2d. 748 (E.D. Mich. 2003), modified, 278 F. Supp. 2d 844 (E.D. Mich. 2003)	U.S. District Court	§163 and §72 Interest expenses and Insurance expenses	No	Taxpayer

TABLE 3
TRADE OR BUSINESS EXPENSES (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Edwards	T.C. Memo. 2002-169	U.S. Tax Court	§162, §274, §280A Deductions for business expenses	No	IRS
Fedex Corp.	91 A.F.T.R.2d (RIA) 1940 (W.D. Tenn. 2003)	U.S. District Court	§162 and §263 Deductibility of cost of repairs to jet aircraft engines and auxiliary power units	No	IRS
Frederick	T.C. Summ. Op. 2003-62	U.S. Tax Court	§ 162 and § 274 Travel expenses and veterinary care fees	Yes	IRS
FRGC Inv., LLC	T.C. Memo. 2002-276	U.S. Tax Court	§ 162, § 263, § 165 Deductible abandonment loss claimed.	No	IRS
Griffiths	54 Fed. Cl. 198 (2002)	U.S. Court of Federal Claims	§1341 –Claim of right Doctrine on payment of the settlement amount §162 Payment as business expense deduction.	No	IRS
Guarna	T.C. Summ. Op. 2003-65	U.S. Tax Court	§ 162 Business expenses deductions. Used Cohan's rule.	Yes	Split Decision
Haas & Assocs.	91 A.F.T.R. 2d (RIA) 833 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	§162 Business expense deduction – Transitional accounting services	No	IRS
Haffner	326 F.3d 1 (1st Cir. 2003)	U.S. Court of Appeals 1st Circuit	§ 162, §531-37 Reasonable compensation	No	IRS

TABLE 3
TRADE OR BUSINESS EXPENSES (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Hartz	T.C. Summ. Op. 2003-25	U.S. Tax Court	§162, §274 – Business expense deduction	No	IRS
Higbee	T.C. Summ. Op. 2002-128	U.S. Tax Court	§162 Business Expense Deduction	No	IRS
Holt	90 A.F.T.R.2d (RIA) 5082 (D. Ariz. 2002)	U.S. District Court	§162 Litigation expenses paid through corporate bank account	Yes	Taxpayer
Huang	T.C. Summ. Op. 2002-93	U.S. Tax Court	§162, 280A Home Office deduction. Deduction for repayment of principal on a bank loan	Yes	Split Decision
Interex	321 F.3d 55 (1st Cir. 2003)	U.S. Court of Appeals 1st Circuit	§162 –Business expenses- legal and accounting service	No	IRS
Jackson	90 A.F.T.R.2d (RIA) 6985 (6th Cir. 2002)	U.S. Court of Appeals 6th Circuit	§ 162 – Schedule C business expenses	Yes	IRS
Jacobsen	T.C. Summ. Op. 2002-87	U.S. Tax Court	§162 and 274 Car and truck, meals & entertainment, legal expenses	Yes	IRS
Jaramillo	T.C. Summ. Op. 2002-118	U.S. Tax Court	§ 162 §274 – Business expense deductions	Yes	IRS
Johnson	T. C. Memo. 2002-239	U.S. Tax Court	§162, §274, §6001 Travel & entertainment substantiation issue.	Yes	IRS

TABLE 3
TRADE OR BUSINESS EXPENSES (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Kay	T.C. Memo. 2002-197	U.S. Tax Court	§ 162, 179, 274 Various Schedule C business expenses.	No	IRS
Kernan	T.C. Summ. Op. 2002-148	U.S. Tax Court	§162, 274 Deduction for living expenses while away from home	Yes	IRS
Maxie	T.C. Summ. Op. 2002-113	U.S. Tax Court	§162, 274 Travel & entertainment expense deductions	Yes	IRS
McGrath	T.C. Memo. 231, aff'd, 92 A.F.T.R.2d (RIA) 6159 (5th Cir. 2003)	U.S. Tax Court	§ 162, §263 - Nondeductible capital improvement. Permanent improvement on leasehold	Yes	IRS
McNeill	T.C. Memo. 2003-65	U.S. Tax Court	§§162 and 274 Trucker had no permanent home so travel and meal expenses not allowed.	Yes	IRS
Middleton	T.C. Memo. 2002-164	U.S. Tax Court	§ 162 Business expense deductions	Yes	IRS
Neonatology Assocs.	P.A., 299 F.3d 221 (3d Cir. 2002)	U.S. Court of Appeals 3rd Circuit	§162 Excessive deductions to into VERA plans (life insurance)	No	IRS
Nunn	T.C. Memo. 2002-250	U.S. Tax Court	§162 Schedule C expenses	Yes	IRS
Pacileo	T.C. Summ. Op. 2003-17	U.S. Tax Court	§§162 §6662 Schedule C expenses	No	IRS
Perrah	T.C. Memo. 2002-283	U.S. Tax Court	§§ 162 and 6662(a) Schedule C expenses	No	IRS

TABLE 3
TRADE OR BUSINESS EXPENSES (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Pratt	T.C. Memo. 2002-279	U.S. Tax Court	§§ 162 and 274 Rent and entertainment expenses	Yes	IRS
Radnitz	T.C. Summ. Op. 2003-29	U.S. Tax Court	§162 and §280A Home Office expense deductions	Yes	IRS
Reynolds	296 F.3d 607 (7th Cir. 2002)	U.S. Court of Appeals 7th Circuit	§§ 162 and 274 Legal expenses not business related. Travel expenses unsubstantiated	Yes	IRS
Sams	T.C. Summ. Op. 2002-95	U.S. Tax Court	§162 – Business expense deductions	Yes	Taxpayer
Saykally	T.C. Memo 2003-152	U.S. Tax Court	§162 and §174 Research & experimental expenditures	No	IRS
Smith	T.C. Summ. Op. 2003-16	U.S. Tax Court	§§ 162 and 6662(a) Schedule C expense deductions	Yes	IRS
Stewart	T.C. Memo. 2002-199	U.S. Tax Court	§§ 162 and 6662(a) Payment made to corporation for management fees as deductible expenses.	No	IRS
Suter	T.C. Summ. Op. 2003-22	U.S. Tax Court	§162 – Business expense deductions	Yes	IRS
Townsend Indus.	90 AFTR2d (RIA) 6588 (S.D. Iowa 2002), rev'd, 342 F. 3d 890 (8th Cir. 2003).	U.S. District Court	§162 and §274 Fishing trips for the corporation's employees	No	IRS

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TABLE 3
TRADE OR BUSINESS EXPENSES (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Triplett	90 A.F.T.R.2d (RIA) 7777 (2003)	U.S. Court of Appeals 6th Circuit	§162 Schedule C expenses.	Yes	IRS
Vanalco	300 F. 3d 1023 (9th Cir. 2002)	U.S. Court of Appeals 9th Circuit	§162 and § 263 Deductibility of expenses related to replacing the lining of aluminum smelting machines and portions of its facility's floor.	No	IRS
Vons Cos.	55 Fed. Cl. 709 (2003)	U.S. Court of Federal Claims	§404(a)(6) Contributions made to pension plan after the close of the fiscal year.	No	IRS
Winter	T.C. Memo. 2002-173	U.S. Tax Court	§162, 263 Capitalization of legal and consulting fees related to acquisition of property.	No	IRS
Wood	91 A.F.T.R.2d (RIA) 502 (S. D. Fla. 2002)	U.S. District Court	§§162, 164 and 165 Deductibility of forfeited monies	No	IRS

TABLE 4
ACCURACY-RELATED PENALTY FOR NEGLIGENCE

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Taxpayers (Issues Other Than Business)					
Albach	T.C. Summ. Op. 2002-85	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Brown	T.C. Summ. Op. 2002-91	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Chambers	T.C. Summ. Op. 2002-105	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Cisneros	T.C. Summ. Op. 2002-73	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Fatta	T.C. Summ. Op. 2002-99	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Favia	T.C. Memo. 2002-154	U.S. Tax Court	Accuracy-related penalty for negligence	No	Taxpayer
Jones	T.C. Memo. 2003-131	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Lavigne	T.C. Summ. Op. 2002-81	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Pacheco	T.C. Summ. Op. 2002-82	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Parrett	T.C. Summ. Op. 2002-72	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Peters	T.C. Summ. Op. 2003-10	U.S. Tax Court	Accuracy-related penalty for negligence	No	Split Decision
Purcell	T.C. Summ. Op. 2002-144	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Saunders	T.C. Memo. 2002-143, aff'd, 92 A.F.T.R. 2d (RIA) 6172 (6th Cir. 2003)	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	Split Decision
Wagner	T.C. Summ. Op. 2002-97	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
White	T.C. Summ. Op. 2002-70	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS

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TABLE 4
ACCURACY-RELATED PENALTY FOR NEGLIGENCE (CONT.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Wiley	T.C. Summ. Op. 2002-116	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Williams	T.C. Memo. 2003-97	U.S. Tax Court	Accuracy-related penalty for negligence	No	IRS
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)					
Estate of Ballantyne[1]	T.C. Memo. 2002-160, aff'd, 341 F.3d 802 (8th Cir. 2003)	U.S. Tax Court	Accuracy-related penalty for negligence	No	Split Decision
Best Auto Sales, Inc.	T.C. Memo. 2002-297	U.S. Tax Court	Accuracy-related penalty for negligence	No	IRS
Blankson	T.C. Summ. Op. 2003-12	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
DAK, Inc.	T.C. Summ. Op. 2003-52	U.S. Tax Court	Accuracy-related penalty for negligence	No	IRS
Fowler	T.C. Memo. 2002-223	U.S. Tax Court	Accuracy-related penalty for negligence	No	Taxpayer
Frederick	T.C. Summ. Op. 2003-62	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Heidrick	T.C. Summ. Op. 2002-115	U.S. Tax Court	Accuracy-related penalty for negligence	No	IRS
Hill	T.C. Memo. 2003-144	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Indeck Energy Services, Inc.	T.C. Memo. 2003-101	U.S. Tax Court	Accuracy-related penalty for negligence	No	Taxpayer
Jahina	T.C. Summ. Op. 2002-150	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	Taxpayer
Jaramillo	T.C. Summ. Op. 2002-118	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Johnson	T.C. Memo. 2002-239	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Middleton	T.C. Memo. 2002-164	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Montgomery	T.C. Memo. 2003-64	U.S. Tax Court	Accuracy-related penalty for negligence	No	Split Decision

TABLE 4
ACCURACY-RELATED PENALTY FOR NEGLIGENCE (CONT.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Neonatology Assocs., P.A.	299 F.3d 221 (3d Cir. 2002)	U.S. Court of Appeals 3rd Circuit	Accuracy-related penalty for negligence	No	IRS
Ngosso	T.C. Summ. Op. 2002-154	U.S. Tax Court	Accuracy-related penalty for negligence	No	IRS
Nunn	T.C. Memo. 2002-250	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Pacileo	T.C. Summ. Op. 2003-17	U.S. Tax Court	Accuracy-related penalty for negligence	No	IRS
Perrah	T.C. Memo. 2002-283	U.S. Tax Court	Accuracy-related penalty for negligence	No	IRS
Rinehart	T.C. Memo. 2003-109	U.S. Tax Court	Accuracy-related penalty for negligence	No	IRS
Satriana	T.C. Summ. Op. 2002-84	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Saykally	T.C. Memo. 2003-152	U.S. Tax Court	Accuracy-related penalty for negligence	No	Split Decision
Smith	T.C. Summ. Op. 2003-16	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS
Smith	T.C. Summ. Op. 2003-28	U.S. Tax Court	Accuracy-related penalty for negligence	Yes	IRS

[1] The cases of the Estate of Melvin W Ballantyne and Russell and Clarice Ballantyne were consolidated for the purpose of trial, briefing and opinion. The accuracy-related penalty for negligence was at issue only for Russell and Clarice Ballantyne.

TABLE 5
EARNED INCOME TAX CREDIT ACCURACY-RELATED PENALTY FOR NEGLIGENCE

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Allah	T.C. Summ. Op. 2003-37	U.S. Tax Court	EITC with qualifying children and dependency exemption deductions	Yes	Split Decision
Anderson	T.C. Summ. Op. 2002-103	U.S. Tax Court	EITC with qualifying children, dependency exemption, Head-of-Household filing status, child tax credit and additional child tax credit	Yes	IRS
Barrie	T.C. Summ. Op. 2002-80	U.S. Tax Court	EITC with qualifying children, dependency exemption and Head-of-Household filing status	Yes	IRS
Carter	T.C. Summ. Op. 2002-107	U.S. Tax Court	EITC with qualifying children, dependency exemption and Head-of-Household filing status	Yes	IRS
Chandler	T.C. Summ. Op. 2002-74	U.S. Tax Court	EITC with a qualifying child	Yes	Split Decision
Christie	T.C. Summ. Op. 2003-48	U.S. Tax Court	EITC with a qualifying child, dependency exemption and Head-of-Household filing status	Yes	Split Decision
Coats	T.C. Memo. 2003-78	U.S. Tax Court	EITC with qualifying children	Yes	Split Decision
Demars	279 BR 548 (Bankr. W.D. Mo. 2002)	U.S. Bankruptcy Court	Objection to exemption of EITC and tax refund from bankruptcy proceedings by trustee	No	Objection sustained
Dewald	T.C. Summ. Op. 2002-75	U.S. Tax Court	EITC with qualifying children, dependency exemption and Head-of-Household filing status	Yes	IRS

TABLE 5
EARNED INCOME TAX CREDIT ACCURACY-RELATED PENALTY FOR NEGLIGENCE (CONT.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Duvall	281 BR 646 (Bankr. W.D. Kentucky 2002), rev'd Flannery v. Mathison, 289 B.R. 624(W.D. Ky.2003)	U.S. Bankruptcy Court	Objection to exemption of EITC portion of tax refund from bankruptcy proceedings by trustee	No	Objection sustained.
Flanery	289 BR 624 (W.D. Kentucky 2003)	U.S. District Court	Appeal from the US Bankruptcy Court for the Western District of Kentucky – does EITC qualify as "public assistance" entitled to exemption under Kentucky law	No	Decision reversed. EITC can be public assistance under KY law.
Floyd	T.C. Summ. Op. 2002-92	U.S. Tax Court	EITC with a qualifying child, dependency exemption, Head-of-Household filing status	Yes	IRS
Gilbert	T.C. Summ. Op. 2003-9	U.S. Tax Court	EITC with a qualifying child, dependency exemption and Head-of-Household filing status	Yes	IRS
Gingrich	T.C. Summ. Op. 2002-158	U.S. Tax Court	EITC with qualifying children, dependency exemption and Head-of-Household filing status	Yes	Taxpayer
Hayword	T.C. Memo. 2002-258	U.S. Tax Court	EITC with a qualifying child, dependency exemption, Head-of-Household filing status	Yes	Split Decision (Note: Issues resolved in favor of taxpayer were conceded)

TABLE 5
EARNED INCOME TAX CREDIT ACCURACY-RELATED PENALTY FOR NEGLIGENCE (CONT.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Hegwood	T.C. Summ. Op. 2002-156	U.S. Tax Court	EITC with qualifying children, dependency exemption, Head-of-Household filing status	Yes	Split Decision (Note Issues resolved in favor of taxpayer were conceded)
Hubbard	T.C. Summ. Op. 2002-109	U.S. Tax Court	EITC with qualifying children, dependency exemption and Head-of-Household filing status	Yes	IRS
Israel	91 A.F.T.R.2d (RIA) 1934 (D. Conn. 2003)	U.S. District Court	Whether EITC credits were "paid" within three years of the date the claims for refund were filed	No	IRS
Jones	T.C. Summ. Op. 2003-66	U.S. Tax Court	EITC with qualifying children and dependency exemption	Yes	IRS
Kalubi	T.C. Summ. Op. 2003-64	U.S. Tax Court	EITC with qualifying children and dependency exemption	Yes	IRS
McGee	T.C. Summ. Op. 2002-69	U.S. Tax Court	EITC with qualifying children, dependency exemption, Head-of-Household filing status	Yes	IRS
McGee	T.C. Summ. Op. 2002-100	U.S. Tax Court	EITC with qualifying children, dependency exemption and Head-of-Household filing status	Yes	IRS
Meier	T.C. Summ. Op. 2002-131	U.S. Tax Court	EITC with qualifying children, dependency exemption and Head-of-Household filing status	Yes	Taxpayer

TABLE 5
EARNED INCOME TAX CREDIT ACCURACY-RELATED PENALTY FOR NEGLIGENCE (CONT.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Merriweather	T.C. Memo 2002-226	U.S. Tax Court	EITC with a qualifying child, a dependency exemption and Head-of-Household filing status	Yes	IRS
Pelayo	T.C. Summ. Op. 2003-20	U.S. Tax Court	EITC with qualifying children and Head-of-Household filing status	Yes	IRS
Pelayo-Zabalza	T.C. Summ. Op. 2002-134	U.S. Tax Court	EITC with qualifying children, dependency exemption and Head-of-Household filing status	Yes	Split Decision (Note Issues resolved in favor of taxpayer were conceded)
Sharp	286 BR 627 (Bankr. E.D. Ky. 2002)	U.S. Bankruptcy Court	Creditor (IRS) motion for release from automatic stay to exercise setoff rights (taxpayer claimed EITC and tax refund as exempt from bankruptcy proceedings)	No	Split Decision. EITC exempt remainder of subject to offset. Relief from automatic stay granted.
Sliwinski	T.C. Summ. Op. 2003-49	U.S. Tax Court	EITC with qualifying children, dependency exemption and Head-of-Household filing status	Yes	Taxpayer

TABLE 5
EARNED INCOME TAX CREDIT ACCURACY-RELATED PENALTY FOR NEGLIGENCE (CONT.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Tomczyk	295 B.R. 894 (Bankr. D. Minn. 2003)	U.S. Bankruptcy Court	Objection to exemption of EITC and Minnesota Working Family Credit (MFIP) tax refunds from bankruptcy proceedings by trustee	No	Split Decision. EITC and MFIP exempt – balance of refunds not exempt.
Tovar	T.C. Summ. Op. 2003-35	U.S. Tax Court	EITC with a qualifying child, a dependency exemption and Head-of-Household filing status	Yes	Split Decision
Trent	T.C. Memo. 2002-285	U.S. Tax Court	Whether taxpayer is barred from relief on the basis of res judicata under § 6015(g)(2) and whether application of overpayments (including EITC) for subsequent years violates section 6015(e)(1)(B)	No	IRS

TABLE 6
FAILURE TO FILE PENALTY

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Individual Taxpayers (Issues Other Than Business)					
Aston	T.C. Memo. 2003-104	U.S. Tax Court	Failure to file penalty	Yes	IRS
Cabirac	120 T.C. 163 (2003)	U.S. Tax Court	Failure to file penalty	Yes	IRS
Hess	T.C. Summ. Op. 2002-90	U.S. Tax Court	Failure to file penalty	Yes	IRS
Hilvety	T.C. Memo. 2003-119	U.S. Tax Court	Failure to file penalty	Yes	IRS
Kilson	T.C. Summ. Op. 2003-44	U.S. Tax Court	Failure to file penalty	Yes	IRS
Kinslow	T.C. Memo. 2002-313	U.S. Tax Court	Failure to file penalty	Yes	IRS
Maher	T.C. Memo. 2003-85	U.S. Tax Court	Failure to file penalty	Yes	IRS
Mantakounis	T.C. Memo. 2002-306	U.S. Tax Court	Failure to file penalty	No	IRS
Meyer	T.C. Memo. 2003-12	U.S. Tax Court	Failure to file penalty	Yes	Taxpayer
Miner	T.C. Memo. 2003-39	U.S. Tax Court	Failure to file penalty	Yes	IRS
O'Toole	T.C. Memo. 2002-265	U.S. Tax Court	Failure to file penalty	Yes	IRS
Russo	T.C. Summ. Op. 2002-88	U.S. Tax Court	Failure to file penalty	Yes	IRS
Sawukaytis	T.C. Memo. 2002-156	U.S. Tax Court	Failure to file penalty	Yes	IRS
Witcher	T.C. Memo. 2002-292	U.S. Tax Court	Failure to file penalty	Yes	IRS
Woodall	T.C. Memo. 2002-318	U.S. Tax Court	Failure to file penalty	Yes	IRS
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)					

TABLE 6
FAILURE TO FILE PENALTY (CONT.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Burnett	A.F.T.R. 2d (RIA) 2376 (5th Cir. 2003)	U.S. Court of Appeals 5th Circuit	Failure to file penalty	Yes	IRS
Cohen	T.C. Memo. 2003-42	U.S. Tax Court	Failure to file penalty	No	IRS
Flores	T.C. Summ. Op. 2003-56	U.S. Tax Court	Failure to file penalty	Yes	IRS
Guarna	T.C. Summ. Op. 2003-65	U.S. Tax Court	Failure to file penalty	Yes	IRS
Hartz	T.C. Summ. Op. 2003-25	U.S. Tax Court	Failure to file penalty	No	IRS
Hastings	T.C. Memo. 2002-310	U.S. Tax Court	Failure to file penalty	Yes	IRS
Heidrick	T.C. Summ. Op. 2002-115	U.S. Tax Court	Failure to file penalty	No	IRS
Hill	T.C. Memo. 2003-144	U.S. Tax Court	Failure to file penalty	Yes	IRS
JHK Enters. Inc.	T.C. Memo. 2003-79	U.S. Tax Court	Failure to file penalty	No	IRS
Johnson	T.C. Memo. 2002-239	U.S. Tax Court	Failure to file penalty	Yes	IRS
Kuberski	T.C. Memo. 2002-200	U.S. Tax Court	Failure to file penalty	Yes	IRS
Middleton	T.C. Memo. 2002-164	U.S. Tax Court	Failure to file penalty	Yes	IRS
Nunn	T.C. Memo. 2002-250	U.S. Tax Court	Failure to file penalty	Yes	IRS
Smith	T.C. Summ. Op. 2003-28	U.S. Tax Court	Failure to file penalty	Yes	IRS
Spurlock	T.C. Memo. 2003-124	U.S. Tax Court	Failure to file penalty	Yes	IRS
Turner	T.C. Summ. Op. 2003-6	U.S. Tax Court	Failure to file penalty	Yes	IRS

TABLE 7
CHARITABLE CONTRIBUTIONS

Name	Citation	Court	Issue(s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)					
Addis	118 T.C. 528 (2002)	U.S. Tax Court	Charitable contributions quid pro quo	No	IRS
Albach	T.C. Summ. Op. 2002-85	U.S. Tax Court	Charitable contributions, unreimbursed employee expenses	Yes	IRS
Bowers	T.C. Summ. Op. 2003-57	U.S. Tax Court	Charitable contributions, unreimbursed employee expenses	No	IRS
Brown	T.C. Summ. Op. 2002-91	U.S. Tax Court	Charitable contributions, unreimbursed employee expenses	Yes	IRS
Chambers	T.C. Summ. Op. 2002-105	U.S. Tax Court	Charitable contributions, unreimbursed employee expenses	Yes	Split Decision
Cisneros	T.C. Summ. Op. 2002-73	U.S. Tax Court	Charitable contributions, unreimbursed employee expenses	Yes	Taxpayer
Fatta	T.C. Summ. Op. 2002-99	U.S. Tax Court	Charitable contributions, rental real estate expenses	Yes	Split Decision
Lavigne	T.C. Summ. Op. 2002-81	U.S. Tax Court	Charitable contributions, gambling loss	Yes	Split Decision
Pacheco	T.C. Summ. Op. 2002-82	U.S. Tax Court	Charitable contributions	Yes	Split Decision
Parrett	T.C. Summ. Op. 2002-72	U.S. Tax Court	Charitable contributions, unreimbursed employee expenses	Yes	Split Decision
Wagner	T.C. Summ. Op. 2002-97	U.S. Tax Court	Charitable contributions, unreimbursed employee expenses	Yes	IRS
Weiner	T.C. Memo. 2002-153	U.S. Tax Court	Charitable contributions	No	IRS
Weyts	T.C. Memo. 2003-68	U.S. Tax Court	Charitable contributions, education loan interest	Yes	IRS

TABLE 7
CHARITABLE CONTRIBUTIONS (CONT.)

Name	Citation	Court	Issue(s)	Pro Se	Decision
White	T.C. Summ. Op. 2002-70	U.S. Tax Court	Charitable contributions, unreimbursed employee expenses	Yes	IRS
Wiggins	T.C. Summ. Op. 2002-139	U.S. Tax Court	Charitable contributions, Miscellaneous itemized Deductions, filing status	Yes	IRS
Wiley	T.C. Summ. Op. 2002-116	U.S. Tax Court	Charitable contributions, unreimbursed employee expenses	Yes	Split decision
Business Taxpayers (Sole Proprietorships, including Schedules C and F, Schedule E, Corporations, Partnerships and Trusts)					
Blankson	T.C. Summ. Op. 2003-12	U.S. Tax Court	Charitable contributions, child care credit, theft loss, self-employment expenses	Yes	IRS
Jaramillo	T.C. Summ. Op. 2002-118	U.S. Tax Court	Charitable contributions, self employment expenses	Yes	IRS
Satriana	T.C. Summ. Op. 2002-84	U.S. Tax Court	Charitable contributions, itemized taxes and mortgage interest, gambling losses	Yes	Split Decision
Smith	T.C. Summ. Op. 2003-16	U.S. Tax Court	Charitable contributions, Unreimbursed employee expenses	Yes	IRS
Whitehurst	T.C. Summ. Op. 2003-7	U.S. Tax Court	Charitable contributions, self employment expenses	Yes	IRS

TABLE 8
ABUSIVE TRUSTS

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)					
Adorno Asset Mgmt Trust	T.C. Memo. 2003-127	U.S. Tax Court	Assessment sustained	Yes	IRS
Ballard	321 F. 3d 1037 (11th Cir. 2003)	U.S. Court of Appeals 11th Circuit	Assessment sustained	No	IRS
DeMott	91 A.F.T.R. 2d (RIA) 751 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Conviction upheld	No	IRS
Edwards	T.C.Memo. 2002-169	U.S. Tax Court	Assessment sustained	No	IRS
George	T.C.Memo. 2002-163	U.S. Tax Court	Assessment sustained	Yes	IRS
Lund	90 A.F.T.R. 2d (RIA) 5242 (9th Cir. 2002)	U.S. Court of Appeals 9th Circuit	Assessment sustained	No	IRS
Mahoney	2002 U.S. Dist. LEXIS 19617 (D. Mass. 2002)	U.S. District Court	Injunction	Yes	IRS
Nichols	T.C. Memo. 2003-24	U.S. Tax Court	Assessment sustained	Yes	IRS
Nipper	91 A.F.T.R. 2d (RIA) 1846 (N.D. Okla. 2003)	U.S. District Court	Collection	Yes	IRS
Novotny	90 A.F.T.R. 2d (RIA) 5684 (D. Colo. 2002) aff'd. 92 A.F.T.R.2d (RIA) 5648 (10TH Cir. 2003)	U.S. District Court	Collection	Yes	IRS
Prater	2002 U.S. Dist. LEXIS 25685 (M.D. Fla. 2002)	U.S. District Court	Injunction	No	IRS
Ratfield	90 A.F.T.R. 2d (RIA) 7076 (S.D. Fla. 2002)	U.S. District Court	Injunction	No	IRS
Richmond	90 A.F.T.R. 2d (RIA) 6353 (N.D. Ill. 2002)	U.S. District Court	Injunction	Yes	IRS
Rowen	298 B.R. 641 (Bankr. D. Alaska 2003)	U.S. Bankruptcy Court	Assessment sustained	No	IRS

TABLE 8
ABUSIVE TRUSTS (CONT.)

NAME	CITATION	COURT	ISSUE(S)	PRO SE	DECISION
Spiwak	285 B.R. 744 (S.D. Fla. 2002)	U.S. District Court	Collection	No	IRS
Ward	T.C.Memo. 2002-147	U.S. Tax Court	Assessment sustained	Yes	IRS
Welti	90 A.F.T.R. 2d (RIA) 7472 (S.D. Ohio 2002)	U.S. District Court	Injunction	Yes	IRS

TABLE 9
ACTIVITY NOT ENGAGED IN FOR PROFIT (HOBBY LOSS)

Name	Citation	Court	Issue(s)	Pro Se	Decision
Business Taxpayers (Sole Proprietorships, including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)					
Baldwin	T.C. Memo. 2002-162	U.S. Tax Court	Lodge / Vacation Home and Aircraft Transportation	No	IRS
Carino	T.C. Summ. Op. 2002-140	U.S. Tax Court	Performing Arts Management	Yes[1]	IRS
Hastings	T.C. Memo. 2002-310	U.S. Tax Court	Horse Breeding / Training / Sales	Yes[2]	IRS
Heidrick	T.C. Summ. Op. 2002-115	U.S. Tax Court	Gold Mining	No	IRS
Hogan	T.C. Summ. Op. 2003-8	U.S. Tax Court	Bed and Breakfast / Inn	No	IRS
Kuberski	T.C. Memo. 2002-200	U.S. Tax Court	Horse Breeding / Racing	Yes	IRS
Lopez	T.C. Memo. 2003-142	U.S. Tax Court	Multi-level Marketing (Amway)	Yes	IRS
Mayo	T.C. Summ. Op. 2003-51	U.S. Tax Court	Used Automobile Sales	Yes	IRS
Montgomery	T.C. Memo. 2003-64	U.S. Tax Court	Miscellaneous Sales	No	IRS
Prieto	91 A.F.T.R.2d (RIA) 1423 (9th Cir. 2003)	U.S. Court of Appeals 9th Circuit	Horse Training / Sales	No	IRS
Schwartz	T.C. Memo. 2003-86	U.S. Tax Court	Yacht Racing	No	Taxpayer
Turner	T.C. Summ. Op. 2003-6	U.S. Tax Court	Automobile Racing	Yes	IRS
Whitehurst	T.C. Summ. Op. 2003-7	U.S. Tax Court	Bowling	Yes	Taxpayer
Zarins[3]	89 A.F.T.R.2d (RIA) 3041 (6th Cir. 2002)	U.S. Court of Appeals 6th Circuit	Tree Farm	Yes	IRS

TABLE 10
INTEREST DEDUCTIONS

NAME	CITATION	COURT	ISSUE	PRO SE	DECISION
Individual Taxpayers (Issues Other Than Business)					
Boehme	T.C. Memo. 2003-81	U.S. Tax Court	Interest expense on repayment of loans secured by lottery winnings.	Yes	IRS
Lenehan	T.C. Summ. Op. 2002-124	U.S. Tax Court	Limitation on the investment interest expense deduction included a long-term capital loss carryover.	No	IRS
Business Taxpayers (Sole Proprietorships, including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)					
Boler	T.C. Memo 2002-155	U.S. Tax Court	Wholly owned corporation's payments to taxpayer are constructive dividends.	No	IRS
Huang	T.C. Summ. Op. 2002-93	U.S. Tax Court	Repayment of loan principal disallowed interest expense allowed.	Yes	Split Decision
CM Holdings, Inc., et al	90 A.F.T.R.2d (RIA) 5850	U.S. Court of Appeals 3rd Circuit	Deduction of interest paid on indebtedness incurred to carry life insurance policy.	No	IRS
Dow Chemical Company and Subsidiaries	91 A.F.T.R.2d (RIA) 1489 E.D. Mich., Northern Division	U.S. District Court	Deduction of interest paid on indebtedness incurred to carry life insurance policy	No	Taxpayer
Edwards	T.C. Memo 2002-169	U.S. Tax Court	Mortgage interest related to office in the home	No	IRS
Guarna	T.C. Summ. Op. 2003-65	U.S. Tax Court	Mortgage interest substantiation	Yes	Split Decision
Hartz	T.C. Summ. Op. 2003-25	U.S. Tax Court	Business interest substantiation	No	IRS

TABLE 10
INTEREST DEDUCTIONS (CONT.)

NAME	CITATION	COURT	ISSUE	PRO SE	DECISION
Robinson	119 T.C. 44 (2002)	U.S. Tax Court	Personal interest paid on tax deficiency	No	IRS
Ronald Morgan Cadillac, Inc.	90 A.F.T.R.2d (RIA) 6719	U.S. District Court	Corporation deducts accrued but unpaid interest to shareholder	No	IRS
Smith	T.C. Summ. Op. 2003-16	U.S. Tax Court	Disallowed taxpayer funded ministry which paid personal expenses/ some investment interest expense allowed	Yes	IRS

ACRONYM GLOSSARY

ACRONYM GLOSSARY - ANNUAL REPORT TO CONGRESS 2003

Acronym	Definition
ACTC	Advanced Child Tax Credit
AEITC	Advanced Earned Income Tax Credit
AGI	Adjusted Gross Income
AICPA	American Institute of Certified Public Accountants
ARC	Annual Report to Congress
AQMS	Appeals Quality Measurement System
ASED	Assessment Statute Expiration Date
ASFR	Automated Substitute for Return
ATAO	Application for Taxpayer Assistance Order
AUR	Automated Underreporter
BCIS	Bureau of Citizenship and Immigration Services
BMF	Business Master File
CAWR	Combined Annual Wage Reporting Program
CDP	Collection Due Process
COIC	Centralized Offer In Compromise Program
CONOPS	Concept of Operations
CRIS	Compliance Research Information System
CSED	Collection Statute Expiration Date
CTC	Child Tax Credit
EFTPS	Electronic Filing Tax Payment System
EIN	Employer Identification Number
EITC	Earned Income Tax Credit
ERIS	Enforcement Revenue Information System
ETA	Effective Tax Administration
FAOPS	Field Assistance Operating Procedures
FMS	Financial Management Service
FPLP	Federal Payment Levy Program
FTD	Federal Tax Deposit
FTE	Full Time Equivalent
FY	Fiscal Year
GAO	General Accounting Office
IDFP	IRS Directory for Practitioners
IDRS	Integrated Data Retrieval System
IMF	Individual Master File

ACRONYM GLOSSARY - ANNUAL REPORT TO CONGRESS 2003

Acronym	Definition
IOD	Interactive Organizational Directory
IRC	Internal Revenue Code
IRM	Internal Revenue Manual
IRP	Information Return Program
IRS	Internal Revenue Service
IRSAC	Internal Revenue Service Advisory Committee
ITIN	Individual Taxpayer Identification Number
LEP	Limited English Proficiency
LITC	Low-Income Tax Clinics
LMSB	Large & Mid-Sized Business Operating Division
LRF	Last Return Filed
MAE	Memphis Automated Examination
MFT	Master File Transaction Code
NE-NPIIT	Notice Elimination Notice Proces Improvement Initiative Team
NMF	Non-Master File
NPIIT	Notice Process Improvement Initiative Team
NTA	National Taxpayer Advocate
OBRA	Omnibus Budget Reconciliation Act of 1989
OIC	Offer in Compromise
OPERA	The Office of Program Evaluation, Research, & Analysis
ORG	Organization
RCP	Reasonable Collection Potential
RGS	Report Generating Software
ROFT	Record of Federal Tax Liability
RRA 98	Restructuring and Reform Act of 1998
SB/SE	Small Business/Self Employed Operating Division
SERP	Servicewide Electronic Research Program
SFR	Substitute for Return
SPEC	Stakeholder, Partnership, Education & Communication
SSA	Social Security Administration
SSN	Social Security Number
TAC	Taxpayer Assistance Center
TAS	Taxpayer Advocate Service
TEC	Taxpayer Education & Communication

ACRONYM GLOSSARY - ANNUAL REPORT TO CONGRESS 2003

Acronym	Definition
TE/GE	Tax Exempt & Government Entities Operating Division
TIGTA	Treasury Inspector General for Tax Administration
TPI	Total Positive Income
TPNCs	Taxpayer Notice Codes
TY	Tax Year
VITA	Volunteer Income Tax Assistance
W & I	Wage and Investment Operating Division

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FAX: 787-622-8933

CRITERIA USED TO RANK MOST SERIOUS PROBLEMS

RANKING CRITERIA FOR MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS

Rank	MOST SERIOUS PROBLEM	IMPACT ON TP RIGHTS	TOTAL NUMBER TPS AFFECTED	VISIBILITY/SENSITIVITY/INTEREST				BARRIERS TO TAX LAW COMPLIANCE (COST, TIME, BURDEN)	REVENUE IMPACT OF NON COMPLIANCE	TAMIS
				NTA	STAKE-HOLDERS	CONGRESS	EXTERNAL INDICATORS			
1	Alternative Minimum Tax (AMT) for Individuals	H	H	H	H	H	H	H	H	H
2	Nonfiling and Underreporting by Self-Employed Taxpayers	H	L	H	L	L	L	H	H	L
3	Earned Income Tax Credit (EITC) Compliance Strategy	H	H	H	H	H	M	H	L	H
4	Appeals Implementation of the Collection Due Process (CDP) Program	H	L	H	H	L	L	M	H	H
5	Individual Taxpayer Identification Numbers (ITINS)	H	L	H	H	H	H	H	M	M
6	Combination Letter	H	H	H	M	L	L	H	L	L
7	Offers In Compromise	H	L	H	H	H	H	H	L	H
8	Math Error Authority	H	H	H	H	L	L	H	M	H

CRITERIA USED TO RANK MOST SERIOUS PROBLEMS

RANKING CRITERIA FOR MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS

Rank	MOST SERIOUS PROBLEM	IMPACT ON TP RIGHTS	TOTAL NUMBER TPS AFFECTED	VISIBILITY/SENSITIVITY/INTEREST				BARRIERS TO TAX LAW COMPLIANCE (COST, TIME, BURDEN)	REVENUE IMPACT OF NON COMPLIANCE	TAMIS
				NTA	STAKE-HOLDERS	CONGRESS	EXTERNAL INDICATORS			
9	Navigating the IRS		H	H	H	M	H	H	L	
10	No Response Audit Cases	H	H	H	M	L	L	H	H	L
11	Taxpayer Assistance Centers	M	H	H	H	H	H	M	L	L
12	EITC Outreach & Education	M	H	H	H	M	H	H	L	L
13	EITC Nonfilers	H	H	H	H	M	H	M	H	L
14	Separating Joint Accounts of Spouses (MFT 31)	H	H	H	M	L	L	M	M	H
15	Criminal Investigation Division Freezes	H	L	M	H	M	L	H	L	H
16	Appeals Inventory Delays	L	L	H	H	L	L	H	H	L
17	Federal Tax Deposit (FTD) Penalty	L	H	L	M	L	L	H	H	H
18	Federal Payment Levy Program (FPLP)	H	L	M	L	L	L	L	L	L
19	Manual Refunds	M	L	M	L	M	L	M	L	H
20	Combined Annual Wage Reporting (CAWR) Reconciliation	L	M	H	H	L	L	M	M	M

TAXPAYER ADVOCATE SERVICE

INTERNAL REVENUE SERVICE