NATIONAL TAXPAYER ADVOCATE

2005 ANNUAL REPORT TO CONGRESS

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VOLUME 1

TAXPAYER ADVOCATE SERVICE

INTERNAL REVENUE SERVICE

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This report is dedicated to our friend and former colleague,

Henry O. Lamar, Jr.,

former Deputy National Taxpayer Advocate

and

former Commissioner, Wage & Investment,

who served as a tireless advocate for taxpayers

and IRS employees alike,

and whose dignity and grace in the face of adversity

serve as a model for us all.

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HONORABLE MEMBERS OF CONGRESS:

I respectfully submit for your review the National Taxpayer Advocate's 2005 Annual Report to Congress. This is the fifth such report I have submitted as the National Taxpayer Advocate. More than anything else, this year's report is a call for tax reform. Our tax code has grown so complex it creates opportunities for taxpayers to make inadvertent mistakes as well as to game the system. As the Code gets more complex – especially for individual taxpayers and small businesses – it becomes more difficult for the IRS to provide comprehensive, quality taxpayer service.

As taxpayers become confused and make mistakes, or deliberately "push the envelope", the IRS understandably responds with increased enforcement actions. The exploitation of "loopholes" leads to calls for new legislation to crack down on abuses, which in turn makes the tax law more complex. Thus begins an endless cycle – complexity drives inadvertent error and fraud, which drive increased enforcement or new legislation, which drives additional complexity. In short, complexity begets more complexity. This cycle can only be broken by true tax simplification, followed by ongoing legislative and administrative discipline to avoid subsequent "complexity creep".

Our own contribution to the tax reform debate, though modest, is taxpayer-centric. Among the legislative recommendations included in this report, we first set out some general principles for tax reform, from the perspective of taxpayers. We then submit nine further legislative proposals – some substantive, some procedural, but all involving issues that impose significant burden on taxpayers. Our proposals run the gamut from reform of the Code's six "Family Status" provisions and repeal of joint and several liability for taxpayers who file returns under married-filing-jointly status, to proposals to protect Social Security benefits from IRS levy action. However diverse these proposals may be, we advocate in each for simplification and reduced compliance burdens.

Our report also highlights some significant contrasts. These contrasts are illustrated by the first three issues we identify as Most Serious Problems for taxpayers – trends in taxpayer service, criminal investigation refund freezes, and the cash economy. I am concerned that the IRS is decreasing the level of resources it dedicates to taxpayer service, including lowering the level of service on its toll-free lines and restricting the types and amount of service provided in its walk-in sites. The IRS justifies this reduction in service funding by the need to dedicate more resources to IRS enforcement functions. Yet the IRS is doing little to address the largest component of the tax gap – the cash economy.[1] Meanwhile, the IRS is expending significant resources on a Criminal Investigation program that probably freezes over 300,000 refunds each year (the IRS doesn't keep track of the number), classifies taxpayers as "criminals" without providing them an opportunity to produce exculpatory evidence, continues to automatically freeze those taxpayers' refund claims for years into the future, and causes financial hardship for tens of thousands of

[1] For purposes of this report, we use the term "cash economy" to mean payments for transactions that are not reported to the IRS by third parties.

taxpayers whose claims are legitimate but are nonetheless forced to wait 8 ½ months or longer to receive their refunds. While the first two issues raise questions of resource allocations and organizational priorities, the last issue raises significant taxpayer rights and due process concerns.

Even where there are real successes, we see contrasts. Take the Earned Income Tax Credit (EITC), for example. Although we identify the EITC as a Most Serious Problem, the EITC Program Office and Examination staff have, in fact, been working hard to improve the program by analyzing and redesigning its procedures, learning about the characteristics and limitations of the EITC's target population, and applying that learning to its processes. EITC personnel are open to stakeholder and Taxpayer Advocate Service suggestions and engage them in dialogue. Thus, we identify many significant improvements even as we recommend additional steps.

It is important that the EITC program is making significant improvements, because 48 percent of IRS individual examinations involve the EITC despite the fact that only 17 percent of individual tax returns claim the EITC. This disproportionate attention is driven, in part, by the mandates of the Improper Payments Improvement Act. Here is another contrast: the IRS is vigorously attacking improper payments *to* taxpayers in the EITC but not pursuing equally vigorously the improper nonpayment of tax *by* taxpayers in the cash economy. The IRS is overly focusing on $9 billion of the annual tax gap attributable to low income taxpayers, while inadequately focusing on the estimated $100 billion-plus of the annual tax gap attributable to the cash economy.

We have tried, in our report, to point out alternative approaches to problems, both administrative and legislative, that are taxpayer-friendly and cost-effective, particularly in the long run. Over the next year, the Office of the Taxpayer Advocate will advocate for these positions and thereby seek to help the IRS fulfill its mission of serving taxpayers.

But to return to my initial premise, there comes a time when the only effective systemic change is tax reform grounded in simplification. There is a big constituency for tax simplification, after all – the taxpayers themselves. They are speaking up for reform daily, through the phone calls they make and the letters they send to the IRS, through the number of errors they make on tax returns, through the reluctant decision of a *majority* of them to pay professionals to prepare their tax returns for them, through their growing awareness of the Alternative Minimum Tax. We encourage Congress to listen to these folks and take action. I hope this report will assist in that endeavor.

Respectfully submitted,

Nina E. Olson
National Taxpayer Advocate
31 December 2005

TABLE OF CONTENTS

CONTENTS

MOST SERIOUS PROBLEMS

ENCOUNTERED BY TAXPAYERS

INTRODUCTION

The Internal Revenue Code requires the National Taxpayer Advocate to discuss at least 20 of the most serious problems encountered by taxpayers; this year, the Taxpayer Advocate Service (TAS) analyzed and commented on 21 problems.[1] Taxpayers who contact TAS are a subset of taxpayers who actually encounter problems with the IRS. While it is vital that TAS works to resolve individual cases, we must also pursue an integrated approach to advocacy to successfully identify and resolve recurring, systemic taxpayer problems. The most serious problems reflect a combination of case and systemic issues; particularly in the areas of taxpayer service and criminal investigation refund freezes – the top two most serious problems identified in the 2005 Annual Report to Congress.

Methodology of the Most Serious Problems List

TAS considers a number of factors when evaluating and ranking the most serious problems. The problems discussed in the following section were ranked using the following criteria:

- Impact on taxpayer rights;
- Number of taxpayers affected;
- Interest to the taxpayers, stakeholders, Congress, and the National Taxpayer Advocate;
- Impact of noncompliance on tax administration;
- Barriers to taxpayer compliance, including expense, time, and burden; and
- TAS management information data.

Taxpayer Advocate Management Information System List

Taxpayer cases are tracked on the Taxpayer Advocate Management Information System (TAMIS). These cases can be multifaceted and include problems with more than one tax year. The top 25 case issues listed in Appendix 1 reflect cases in TAMIS based on taxpayer contacts from October 1, 2004 to September 30, 2005.

IRS Response

TAS provides the IRS Operating Division Commissioners with the opportunity to comment on the issues and analysis. The unedited IRS response is published at the end of each most serious problem under the heading "IRS Comments." The National Taxpayer Advocate then remarks on the IRS response and outlines her recommendations.

[1] IRC § 7803(c)(2)(B)(ii)(III).

PROBLEMS

PROBLEM

TOPIC #1 MOST SERIOUS PROBLEM: TRENDS IN TAXPAYER SERVICE

RESPONSIBLE OFFICIALS

Mark E. Matthews, Deputy Commissioner, Services and Enforcement
Richard J. Morgante, Commissioner, Wage and Investment Division
Kevin M. Brown, Commissioner, Small Business/Self-Employed Division
Steve T. Miller, Commissioner, Tax Exempt and Government Entities Division
Deborah Nolan, Commissioner, Large and Mid-Size Business Division

DEFINITION OF PROBLEM

Since the late 1990s the IRS has increased its delivery of quality customer service to taxpayers. In fact, in its current strategic plan, the IRS's first goal is to improve taxpayer service.[1] There are recent signs, however, that this trend may be reversing as the IRS proposes to allocate more resources to collection, examination, and criminal investigation functions and fewer resources to taxpayer service functions. For example, in the last calendar year, the IRS:

- Proposed the elimination of 68 of 400 walk-in sites;[2]
- Eliminated Telefile, Tax Fax, and Package X;[3]
- Discussed the elimination of Electronic Tax Law Assistance (ETLA);[4]
- Reduced the "level of service" on the toll-free phone lines from 87 percent to 83 percent and established a long-term level of service goal of 82 percent beginning in FY 2005;[5] and
- Declared 225 questions "out of scope" for walk-in and 117 questions "out of scope" for toll-free phone assistors.[6]

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[1] IRS, *Pub. 3744, IRS Strategic Plan 2005-2009* 12-17 (June 2004).

[2] IRS, *IRS to Create Efficiencies with Taxpayer Assistance Centers*, IR-2005-63 (Jun. 27, 2005).

[3] IRS, *IRS E-File Available for Extension Filers through Aug. 15 and Beyond*, IR-2005-75 (Jul 20, 2005); IRS, *IRS TaxFax Services*, available at http://www.irs.gov/formspubs/article/0,,id=97730,00.html (last visited Nov. 9, 2005); IRS, *Package X Soon to be Obsolete*, available at http://www.irs.gov/taxpros/article/0,,id=139287,00.html (last visited Nov. 9, 2005).

[4] Treasury Inspector General for Tax Administration, Ref. No. 2005-40-152, *Electronic Tax Law Assistance Program Responses Are Timely and Generally Accurate* 1 (Sept. 2005) (noting the IRS is considering whether to discontinue ETLA for fiscal year 2006). Currently, ETLA is still available on the IRS website at http://www.irs.gov/help/page/0,,id=120294,00.html. Electronic Tax Law Assistant (ETLA) is an IRS service offered through a link on www.irs.gov through which taxpayers and practitioners can email tax law questions directly to the IRS. IRS employees can then pull responses to questions from a database of prewritten answers, thus saving time researching and responding to frequently asked questions.

[5] Statement of Mark W. Everson, *IRS Improves Enforcement and Services in 2005* (Nov. 3, 2005); IRS, *FY 2005 Enforcement and Service Data*, available at http://www.irs.gov/pub/irs-news/fy05_enforcement_and_service_chart.pdf (last visited Nov. 10, 2005). Level of service is the relative success rate of taxpayers calling for assistance and seeking services from a Customer Service Representative. Part of the calculation of results for this measure includes the percentage of call attempts made by taxpayers compared to the number of calls answered by IRS. IRS, *Pub. 3744, IRS Strategic Plan 2005-2009* 18 (June 2004).

[6] IRM § 21.3.4-1, *Scope of Services* (Nov. 01, 2005); IRM § 21.1.1.6.1, *Out of Scope and Limited Service* (Oct. 06, 2005); Accounts Management Out of Scope Procedures, Attachment #1 – Identified Out of Scope Issues.

Moreover, the IRS's FY 2006 budget request proposed a one percent reduction in funding for taxpayer service activities at the same time it proposed an eight percent increase in funding for enforcement activities.[7]

The Senate Committee on Appropriations recently noted that the IRS lacks a concrete plan to provide adequate alternative services to replace the services proposed for reduction or elimination.[8] Additionally, a recent Government Accountability Office (GAO) report observed that the IRS lacks long-term goals for taxpayer service as well as reliable data to understand how changes in service will impact taxpayers.[9]

Despite the lack of long-term goals and an understanding of how changes to service affect taxpayers and voluntary compliance, the IRS is continuing its efforts to "migrate" taxpayers toward electronic services and away from face-to-face contact. In a time of budget constraints, it is understandable that the IRS would make every effort to deliver services to taxpayers through the least costly means possible. In the absence of adequate research and a comprehensive strategy, however, the IRS should not continue with a radical restructuring of taxpayer service. Simply stated, before it alters the mix of service and enforcement, the IRS should spend more time studying what types of services different taxpayer segments need and how best to deliver these services to help taxpayers remain compliant. This study should attempt to describe and quantify the impact any changes to taxpayer service will have on compliance and, ultimately, on revenue collection.

ANALYSIS OF PROBLEM

Background

In general, taxpayers try to comply with the tax laws and are actually doing their best to meet their obligations. Although the IRS functions in part as an enforcement agency, it cannot and should not treat every taxpayer as a criminal or a tax cheat. According to its most recent estimates, the IRS collects approximately 86 percent to 87.7 percent of the known tax dollars due and owing.[10] Thus, only a relatively small portion of tax is not collected, and given the complexities of the tax laws and the vagaries of human existence, a significant amount of noncompliance is clearly attributable to understandable, inadvertent

[7] House Committee on Ways and Means, Statement of Mark Everson, Commissioner, Internal Revenue Service (Apr. 15, 2005).

[8] S. Rep. No. 109-109, at 133 (2005). *See also* Joint Congressional Review, Written Testimony of Raymond T. Wagner, Jr., Chairman, IRS Oversight Board (May, 19, 2005); Senate Committee on Appropriations, Written Statement of James R. White, Director, Strategic Issue, Government Accountability Office and David A. Powner, Director, Information Technology Management Issues, Government Accountability Office (Apr. 27, 2005); Senate Committee on Appropriations, Written Statement of J. Russell George, Treasury Inspector General for Tax Administration (Apr. 7, 2005); Senate Committee on Appropriations, Written Statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service (Apr. 7, 2005).

[9] Government Accountability Office, GAO-06-51, *IRS Improved Some Filing Season Services, but Long-Term Goals Would Help Manage Strategic Trade Offs* (Nov. 14, 2005).

[10] IRS National Headquarters Office of Research, *Tax Gap Facts and Figures*, March 29, 2005 (after IRS enforcement activities).

errors, or tragic or unforeseen events in people's lives. IRS enforcement activity, although absolutely crucial to fair tax administration, should be necessary for only a small percentage of taxpayers and tax dollars.

In the aftermath of the IRS Restructuring and Reform Act of 1998,[11] the IRS rightly focused on building up its taxpayer service functions. At that time, its fundamental customer service measures were abysmal. The IRS's level of service on the phones was 51 percent and its telephone tax law accuracy rate stood at 74 percent.[12] In short, for many taxpayers seeking assistance from the IRS in complying with their tax obligations, the IRS simply was not at home.

Today, there is real improvement in these same taxpayer service measures. For fiscal year 2005, the IRS's quality measures include toll-free level of service of 83 percent and telephone tax law accuracy of 89 percent.[13]

However, these FY 2005 numbers do not tell the full story. Since 2003, the IRS has correctly sought to increase the staffing available to its traditional enforcement activities after several years of stagnation. But this build-up has come at the expense of customer service – partly because Congress has not accepted the IRS's assessment of its needs and partly because the IRS has apparently decided that the IRS is delivering "good enough" service for United States taxpayers.

In the last three fiscal years, the IRS has:

- Proposed eliminating 68 Taxpayer Assistance Centers (TACs);[14]
- Declared 117 topics out-of-scope for toll free assistors and 225 topics out of scope for TACs;[15]
- Eliminated the ability of taxpayers to talk with remote assistors about out-of-scope questions by phone at many TACs;
- Reduced the number of tax returns prepared in TACs from 665,868 tax returns in FY 2003 to a proposed 305,000 tax returns in FY 2006;[16]

[11] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685.

[12] Annual IRS Restructuring and Reform Act of 1998 Joint Congressional Review, Testimony of Mark W. Everson, Commissioner, Internal Revenue Service (May 20, 2003) (indicating level of service on the telephones for fiscal year 1998); Internal Revenue Service, Publication 55B, *1999 Data Book*, Table 28 (Apr. 2001) (indicating tax law accuracy rate for fiscal year 1999).

[13] Statement of Mark W. Everson, *IRS Improves Enforcement and Services in 2005* (Nov. 3, 2005).

[14] IRS, *IRS to Create Efficiencies with Taxpayer Assistance Centers*, IR-2005-63 (Jun. 27. 2005).

[15] IRM § 21.1.1.6.1, Out of Scope and Limited Service (Oct. 06, 2005); Accounts Management Out of Scope Procedures, Attachment #1 – Identified Out of Scope Issues; IRM § 21.3.4-1, *Scope of Services* (Nov. 01, 2005).

[16] Wage and Investment, *Business Performance Review, Wage and Investment Operating Division, FY 2006*; Wage and Investment, *Business Performance Review, Wage and Investment Operating Division, FY 2005*; Wage and Investment, *Business Performance Review, Wage and Investment Operating Division, FY 2004*; Wage and Investment, *Business Performance Review, Wage and Investment Operating Division, FY 2003.*

- Eliminated Telefile and TaxFax, despite the IRS's claim that it wants taxpayers to migrate to electronic self-help;[17]
- Discussed the possibility of eliminating ETLA;[18]
- Reduced taxpayer service staffing in TACs while increasing collection personnel in the sites, and directing these compliance personnel to conduct collection activities in the TACs during filing season instead of performing traditional filing assistance, despite prior assurances to the contrary;[19]
- Declared disaster relief questions out-of-scope for Stakeholder Partnerships Education and Communication (SPEC) personnel;[20]
- Reduced its Taxpayer Education and Communication (TEC) staffing by 133 positions and reassigned these employees to traditional collection and examination functions;[21] and
- Inadequately staffed its outreach and education function for the Exempt Organizations sector at a time of increased scrutiny of that sector, and underfunded the printing and publishing of excellent educational materials developed by the staff of seven to the point that taxpayers calling to obtain copies are told they are not available.[22]

Perhaps most disturbing of all these developments is the IRS's decision to "dumb down" its *quality* goals for taxpayer service functions even as it ratchets up the *quantity* goals for collection, examination, and Criminal Investigation.[23] In FY 2004, for example, the IRS's phone level of service was 87 percent, which exceeded its FY 2004 performance goal by four percent.[24] This level was a remarkable achievement, considering how low the level of service was five years earlier (51 percent).[25] For FY 2005, however, the IRS set a long-term performance goal of 82 percent – essentially telling its employees that they had gotten *too good* at delivering service to the U.S. taxpayer and

17 IRS, *IRS E-File Available for Extension Filers through Aug. 15 and Beyond*, IR-2005-75 (Jul 20, 2005); IRS, *IRS TaxFax Services*, available at http://www.irs.gov/formspubs/article/0,,id=97730,00.html (last visited Nov. 9, 2005).

18 Treasury Inspector General for Tax Administration, Ref. No. 2005-40-152, *Electronic Tax Law Assistance Program Responses Are Timely and Generally Accurate*, Ref. No. 2005-40-152 1 (Sept. 2005) (noting the IRS is considering whether to discontinue ETLA for fiscal year 2006). Currently, ETLA is still available on the IRS website at http://www.irs.gov/help/page/0,,id=120294,00.html.

19 *See* National Taxpayer Advocate 2004 Annual Report to Congress 15-16.

20 Information provided by Operating Division.

21 As of February 2005, 133 TEC employees accepted voluntary reassignment to compliance positions. Small Business Self-Employed, *Business Performance Review, SBSE Division* (Feb. 7, 2005).

22 *See* Tax Exempt Government Entities Penalty Abatement Most Serious Problem, infra.

23 Treas. Reg. §§ 801.2T, 801.3T, 801.6T.

24 IRS, FY 2005 Enforcement and Service Data, available at http://www.irs.gov/pub/irs-news/fy05_enforcement_and_service_chart.pdf (last visited Nov. 10, 2005); Wage and Investment, Business Performance Review, Wage and Investment Operating Division 12 (Jul. 28, 2004) (noting FY 2004 goal of 83 percent).

25 Annual IRS Restructuring and Reform Act of 1998 Joint Congressional Review, Testimony of Mark W. Everson, Commissioner, Internal Revenue Service (May 20, 2003).

accepting that it is all right to not answer over seven million phone calls.[26] The IRS is taking these actions despite a statutory directive that "[t]he Commissioner shall continue to make the improvement of the Internal Revenue Service 1-800 help line service a priority and allocate resources necessary to increase phone lines and staff to improve the Internal Revenue Service 1-800 help line service."[27] Moreover, the IRS took the position that if it did not receive all of the funding it requested for FY 2006, there would be further cuts to the level of service on the phones.[28]

Similarly, in FY 2005, the tax law accuracy rate was a very impressive 89 percent, up from 80 percent in FY 2004 and 82 percent in FY 2003.[29] What these numbers hide is the IRS's decision to weed out the more difficult questions from the measured base and declare them "out-of-scope." Thus, the quality rate in FY 2004 includes more difficult – and less accurately answered – questions than those measured for FY 2005. This approach might be reasonable if the IRS proposed alternative avenues for taxpayers to obtain answers to their more complicated questions, or at least point them in the right direction. However, this year the IRS discussed eliminating ETLA. More importantly, it declared certain questions completely out-of-scope for R-mail – the program designed to provide taxpayers with guidance on more difficult questions.[30]

Significantly, these actions are taking place without any empirical evidence that the reductions will *not* harm taxpayers and *not* result in decreased compliance. Although the IRS maintains that it is difficult to measure the impact of high quality taxpayer service on compliance, the National Taxpayer Advocate finds that position unpersuasive. Too much is at stake not to conduct the appropriate research and develop cutting edge strategies that will provide world-class taxpayer service.

Assessing the Scope of IRS Service Channels

To develop a long-term strategic plan for delivering world-class taxpayer service, the IRS should start by determining the scope of taxpayer needs. To effectively assess this scope, the IRS should identify all of the taxpayer services it currently offers and all possible channels of communication for offering these services. For each service offered, the goal

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[26] Customer Account Services (CAS) received approximately 40.9 million phone calls directed to telephone assistors in FY 2004. These are calls relating only to taxpayer service issues, and do not include compliance-related telephone calls. Setting the level of service at 82 percent indicates a decision not to answer 18 percent of phone calls, or approximately 7.4 million taxpayer phone calls. Enterprise Telephone Data Warehouse, Enterprise Snapshot for FY 2004 (Oct. 13, 2004).

[27] Department of Treasury FY 2005 Appropriations, H.R. 5025, § 204.

[28] Senate Committee on Appropriations, Testimony of Mark W. Everson, Commissioner, Internal Revenue Service (Apr. 7, 2005).

[29] IRS, FY 2005 Enforcement and Service Data, available at http://www.irs.gov/pub/irs-news/fy05_enforcement_and_service_chart.pdf (last visited Nov. 10, 2005).

[30] For the 2006 filing season, the IRS is revising procedures for referring taxpayers who contact the IRS with out–of-scope questions. Field Assistance and Customer Account Services (CAS) employees who receive out-of-scope inquiries will refer the taxpayer to "seek the services of a tax attorney, certified public accountant (CPA), or other tax professional." The IRS is in the process of updating the IRM to reflect these changes.

should be to determine which channel is most effective for delivering the service.

The IRS offers taxpayers a number of *pre-filing* and *post-filing services*. The main taxpayer services the IRS provides are tax law assistance, account resolution, return preparation, outreach and education, and the distribution of tax forms and publications. Typically, the IRS delivers most taxpayer services through conventional channels of communication – telephone, correspondence, and face-to-face. Recently, the IRS has attempted to deliver a number of services through electronic channels, including the Internet and kiosks.[31] The IRS also uses a number of outside sources to deliver services, including Low Income Taxpayer Clinics (LITCs),[32] Volunteer Income Tax Assistance (VITA), Tax Counseling for the Elderly (TCE),[33] and other programs.

There are additional channels for taxpayer service that the IRS is either under-utilizing or not using at all. These channels include mobile vans, email, instant messaging, text messaging, and interactive voice response software. While some of these options may not be viable at this time, the IRS should explore whether they can be valuable communication channels in the future.

An analysis of the scope of IRS service channels should examine which services each communication channel can deliver and to which demographic group(s). The results of such a study would allow the IRS to quantify the current and projected needs of taxpayers for each possible service and channel. By quantifying the number of taxpayers in each group, the IRS could track how the number of taxpayers using each channel is changing over time. The IRS will also be able to see what the usage of a particular service offered through a specific channel would be if the IRS were delivering the service effectively. This information would be particularly helpful as the IRS continues to migrate toward the electronic delivery of services.

Such research would also allow the IRS to determine the effectiveness of alternative channels in providing different services, including whether taxpayers are able to use the information provided. Similarly, research will determine the efficiency of delivering services through a particular channel. This analysis should include identifying the cost per unit of service delivered, as well as any downstream costs of delivering a service

[31] Kiosks are Internet-enabled locations that provide all of the services offered at a traditional walk-in site, including return preparation, tax law assistance, ordering of forms and publications, and account management. Wage & Investment Division, *Strategic Assessment, Fiscal Year 2005* 11 (2004); Wage & Investment CARE, *Appendix B: Field Assistance ConOps*, slide 2. For a more detailed discussion of the kiosk program, *see* National Taxpayer Advocate 2004 Annual Report to Congress 34-35.

[32] IRC § 7526. The Low Income Taxpayer Clinic (LITC) program provides matching IRS grants to organizations that provide representation to low income taxpayers with a controversy with the IRS or provide outreach and education on tax rights and responsibilities to English as a second language and limited English proficiency taxpayers.

[33] The Volunteer Income Tax Assistance (VITA) program provides free tax preparation to individuals who are unable to afford professional assistance. The Tax Counseling for the Elderly (TCE) program is part of VITA and these sites receive IRS grants to provide free tax assistance to individuals age 60 and older.

through a particular channel.[34] For example, if a taxpayer goes to the IRS website to obtain a tax form and is unable to figure out which form he or she needs, that taxpayer may eventually end up visiting a walk-in site to obtain the correct forms. When determining the cost per unit of delivering tax forms and publications though the Internet, the calculation should attempt to include the downstream cost of the taxpayer having to go into the walk-in site (or other channel) when he was not able to resolve his issue through the Internet. This approach would provide a more accurate estimate of the costs involved in delivering services through various channels.

Finally, the proposed research should identify barriers that inhibit some taxpayer groups from effectively using certain channels to obtain a service. This information may provide insight into why some taxpayers do not use lower cost channels such as the Internet to obtain assistance, but instead continue to use more costly face-to-face services.

Understanding How Taxpayers Prefer to Communicate with the IRS

IRS Research into Taxpayer Preferences

Currently, the IRS only has general information about taxpayer preferences. The most recent information comes from a 2004 IRS Oversight Board Taxpayer Attitude Survey.[35] Since 2002, the IRS Oversight Board has contracted with a professional survey firm to conduct telephone surveys of taxpayers' attitudes, including expectations of IRS customer service. The survey results indicate that individuals rely most highly on IRS publications, IRS representatives, and the IRS website for tax information.[36]

The survey also polled individuals about the importance of various taxpayer services and the likelihood that an individual would use each one. The services with the highest "receptivity" – those services individuals rated as very important and very likely to be used – were an IRS toll-free phone number, an Internet site, walk-in sites, and the ability to email the IRS.[37] These preferences have remained relatively constant since the IRS Oversight Board began this study in 2002.

[34] Downstream costs refer to additional activity "downstream" that results when an initial action (i.e., processing a tax return, resolving a tax dispute, answering a tax law question, or conducting an audit) is not conducted correctly or to the satisfaction of the taxpayer. This additional activity, which may cost the IRS and the taxpayer both time and money, would not have occurred if the initial action operated correctly and effectively. Examples of downstream costs include a tax dispute that goes to Appeals because the dispute could not be resolved during regular processing, a case that comes to TAS because it was not resolved during routine processing, or an original audit that results in an audit reconsideration.

[35] RoperASW, *2004 IRS Oversight Board Taxpayer Attitude Survey* (2004).

[36] In determining the value of IRS-provided information, 82 percent of individuals found IRS representatives and IRS printed publications to be very/somewhat valuable, followed by 77 percent for the IRS website. The only non-IRS information source that ranked equally as high was a paid tax professional, which 81 percent of individuals viewed to be very/somewhat valuable. RoperASW, 2004 *IRS Oversight Board Taxpayer Attitude Survey* (2004).

[37] RoperASW, *2004 IRS Oversight Board Taxpayer Attitude Survey* (2004). The services with low receptivity – those services individuals rated as least important and least likely to be used – were community-based tax clinics, tax assistance vans, and kiosks.

The Wage and Investment Division (W&I) has conducted the majority of IRS research regarding taxpayer preferences to better understand its customer base. Much of W&I's research focuses on the IRS's goal of moving toward the electronic delivery of services. The research has examined taxpayers' online usage and willingness to use electronically delivered services. Although previous research is valuable, the research examined specific issues or demographic groups and does not provide a broad-based view of the preferences of all taxpayers regarding specific services and communication channels.

External Research about Taxpayer Preferences

Most existing information about taxpayers' preferences comes from external sources. While the IRS should consider this information in developing a plan for taxpayer service, the information is not IRS-specific, and its value in identifying taxpayer preference is therefore limited.

The Pew Internet and American Life Project recently conducted a study that examined how Americans get in touch with the government.[38] When asked how they prefer to contact the government, the individuals surveyed favored telephone conversations and websites over in-person contacts and correspondence. Forty percent of respondents preferred the telephone and 24 percent preferred a website, compared with 13 percent preferring in-person contact and 10 percent preferring correspondence.[39]

Individuals' preferences change, however, when they are contacting the government with a very complex or urgent issue or to solve a problem. Although telephone contact remains the most preferred means for these transactions, in-person contact becomes more important, while a website becomes less so.[40]

When asked specifically about contacting the government about tax issues, a majority of respondents prefer the telephone – 51 percent – compared with the 40 percent of respondents who preferred the telephone for non-tax questions.[41] Additionally, 27 percent of respondents who have contacted the government with a tax issue switched their means of contact and almost half of those – 49 percent – changed because they were not getting the response they needed.[42]

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[38] Pew Internet and American Life Project, *How Americans Get in Touch With Government* (May 24, 2004).

[39] *Id.* at 5. Other responses included email, with 11 percent of respondents preferring this means of contact.

[40] In cases of a very complex or urgent problem, 46 percent of respondents preferred to contact the government via telephone, followed by 16 percent preferring in-person and 14 percent preferring a website. When contacting the government to solve a problem, 47 percent of respondents preferred the telephone, compared with 17 percent preferring a web site and 15 percent preferring in-person contact. Pew Internet and American Life Project, *How Americans Get in Touch With Government* 6 (May 24, 2004).

[41] Pew Internet and American Life Project, *How Americans Get in Touch With Government* 13-14 (May 24, 2004).

[42] In comparison, 22 percent of individuals with a non-tax question switched their method of contact and 38 percent of them did so because they were not getting the answer they needed. Pew Internet and American Life Project, *How Americans Get in Touch With Government* 14 (May 24, 2004).

With the IRS's focus on migrating toward electronic delivery of services, another study by the Pew Internet and American Life Project may shed light on which groups of taxpayers are most likely to embrace this change. This Pew study looked specifically at which individuals use government websites.[43] The study found that use of government websites was almost the same for males and females, with 53 percent of males and 47 percent of females having used a government website.[44] The study also found that use of government websites was almost the same despite differences in education levels, with 52 percent of individuals with less than a college education and 48 percent of individuals with a college education or higher having used a government website.[45]

However, disparity in government website usage among certain age groups may highlight an area of particular concern for the IRS. Of those surveyed, only 21 percent of individuals between 18 and 29 have used a government website, while 49 percent of those age 30-49 reported using a government site.[46] As individuals get older, their usage of these sites declines, with 21 percent of individuals between 50 and 64, and only six percent of those 65 and older, reporting they have used a government website.[47]

Similar disparities exist based on income level, with the highest usage of government websites occurring among individuals with the highest income. Individuals in the lowest income bracket were the least likely to use a government site, with 15 percent of individuals with income between $0 - $30,000 reporting use of a government website.[48] Only 22 percent of individuals with income between $30,000 - $50,000 and 19 percent of individuals with income between $50,000 - $75,000 reported having used a government website.[49] Individuals with income over $75,000 were most likely to use a government site, with 30 percent reporting having done so.[50]

While these percentages almost certainly have risen since the study was conducted three years ago, the Pew studies and other similar studies have laid the groundwork for the type of research the IRS must perform. Although current IRS research and various outside studies provide some insight into what taxpayers prefer, the IRS still lacks a comprehensive study indicating what services different groups of taxpayers want and how they prefer to obtain those services. This is the first step we recommend the IRS take to develop a comprehensive strategic plan for taxpayer service.

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43 Pew Internet and American Life Project, *The Rise of the E-Citizen: How People Use Government Agencies' Web Sites* (Apr. 3, 2002).

44 *Id.*

45 *Id.*

46 *Id.*

47 *Id.*

48 *Id.*

49 *Id.*

50 *Id.*

How Taxpayers *Need* to Communicate with the IRS

Once the IRS understands what taxpayers prefer, it should next attempt to determine whether taxpayers' preferences can be changed and if there are any limitations on the IRS's ability to change them.

Although taxpayers may indicate they prefer to use a certain channel, it does not mean that channel is the only one they are willing to use. If a group of taxpayers prefers a higher cost channel, such as face-to-face interaction, the IRS must examine why those taxpayers prefer that channel. By understanding the reasons for the preference, the IRS can determine if, despite the preference, the taxpayers are willing and able to migrate to a different, lower cost channel of communication. This information could also help the IRS determine whether it can modify a lower cost channel to make it more appealing to taxpayers. If taxpayers remain unwilling to migrate, the IRS should have sufficient information to determine whether the compliance benefits justify its continuing to provide the preferred channel, even though it has a lower cost channel for delivering the same service.

In some cases, a taxpayer may indicate she prefers to use a certain channel; however, this preference does not mean she can or will use that channel. In conjunction with looking at taxpayer preferences, the IRS should also look at limitations on a taxpayer's ability to use a certain channel. The characteristics of some groups of taxpayers may prevent them from using certain channels of communication, even if those channels are ones they say they prefer. The IRS must have sufficient information to deal with these challenges.

Disabled Taxpayers

In a 1997, one in five adult Americans reported having a disability and one in eight reported a severe disability.[51] The IRS needs to conduct research as well as review more recent research to determine the most appropriate communications channel for individuals with various disabilities.

Elderly Taxpayers

In 2000, 59 million taxpayers were age 55 or older.[52] This number is expected to grow to 75 million by 2010.[53] This group of taxpayers is significantly less willing to use the Internet to obtain services than the rest of the population. In 2000, only about 13 percent of people over age 65 had access to the Internet.[54] Although Internet usage among older Americans is increasing – 39 percent of Americans over age 50 used the Internet

[51] A person with a disability has difficulty performing functional tasks or daily living activities, or meets other criteria, such as a learning or developmental disability. A person with a severe disability has a complete inability to perform a task or activity, or needs personal assistance to complete an activity. Wage & Investment, *Computer and Internet Use Among People With Disabilities*, slide 3-4.

[52] Wage & Investment, *W&I's Senior Population (Age 55 and Over)*, slide 5 (2003).

[53] *Id.*

[54] Wage & Investment, *Senior Internet Users*, slide 4.

in 2000, compared with 25.5 percent in 1998 – migrating older taxpayers to obtain IRS services electronically will prove difficult.[55] According to the recent IRS Oversight Board study, older individuals (age 65 and older) view the IRS website as the least valuable resource for tax information. Only 19 percent of these older individuals viewed the IRS site as a valuable resource – a 32 point difference in comparison with the total population.[56]

As the IRS continues its move towards the electronic delivery of services, it must plan for and meet the needs of disabled and elderly taxpayers, who have demonstrable difficulty in moving to the Internet.

Low Income Taxpayers

More than 25 percent of W&I filers can be defined as low income.[57] Of those low income taxpayers, over 40 percent live in rural areas or towns.[58] This geographic dispersion can make it extremely difficult for many low income taxpayers to travel long distances to an IRS walk-in site. Although walk-in sites may be inconvenient for many low income taxpayers, these taxpayers are also much less likely than others with higher incomes to have phone or Internet access at home.[59] Low income individuals are more likely to have limited English proficiency and therefore face additional barriers in communication with the IRS.[60]

ESL and LEP Taxpayers

Individuals who speak English as a second language (ESL taxpayers) and those with limited English proficiency (LEP taxpayers) also pose a challenge for the IRS. In 2004, 34.2 million foreign-born persons lived in the U.S.[61] The number of people who do not speak English at home increased from 31.8 million in 1990 to 44.9 million in 2000.[62] An additional 11.6 to 12.8 million people report speaking English "not well" or "not at all."[63] The IRS must address the difficulties associated with communicating with ESL and LEP taxpayers in order to deliver services effectively to this taxpayer group.

The 2003 IRS Oversight Board Compliance Study found that certain demographic

55 Wage & Investment, *Senior Internet Users*, slide 4.

56 RoperASW, *2003 IRS Oversight Board Compliance Study Report* 17 (2003).

57 Wage & Investment, *How Low Income People Are Affected by Commute/Travel Needs*, slide 1 (undated).

58 Wage & Investment, *How Low Income People Are Affected by Commute/Travel Needs*, slide 8 (undated).

59 Wage & Investment, *How Low Income People Are Affected by Commute/Travel Needs*, slide 13 (undated).

60 Wage & Investment, *How Do People Learn English and Progress From One Level of Proficiency to Another?*, slide 17 (2003).

61 Wage & Investment, *America's Workforce: Immigrant Workers*. 4 (2005).

62 Wage & Investment, *How Do People Learn English and Progress From One Level of Proficiency to Another?* slide 2 (2003).

63 *Id.*

groups, specifically Hispanics and Asians, are more likely than average to rely on non-IRS sources for tax advice, such as paid preparers, family, and friends.[64] This tendency may be due in part to a language barrier between the taxpayer and the IRS. This information should be used in deciding whether to offer a specific service through the IRS or through one of the IRS's outside sources. In making this decision, the IRS must assess the accuracy of information provided by such third parties.

Literacy Level of Taxpayers

A study by the Department of Education raises questions about some taxpayers' ability to understand the information the IRS provides. The National Adult Literacy Survey found that between 21 and 23 percent of adult Americans – 40 million to 44 million people – fall at the lowest literacy level.[65] Although many individuals at this level could perform tasks involving simple texts and documents, all individuals in this category had difficulty using certain necessary skills for functioning in everyday life. Individuals at the lowest literacy level can sign their name to and total a bank deposit entry; however, they usually cannot identify and enter background information on a Social Security card application or calculate total costs or purchases from an order form.[66] Given that almost one quarter of all adult Americans fall at the lowest literacy level, the IRS must ascertain how to provide information and services to this segment of the population in a way they can understand. Channels that enable direct observation of the taxpayer's difficulties of communication and comprehension are generally preferable to remote or non-interactive channels.

Impact of Taxpayer Service on Compliance

While it is critical for the IRS to know what services taxpayers need and how best to deliver those services, it is also important for the IRS to understand how any change in taxpayer service will affect compliance. Our current tax system functions on the principle of self-assessment and has resulted in a largely compliant taxpaying population. The IRS's working equation – "Service + Enforcement = Compliance" – recognizes that taxpayer service plays a central role in ensuring taxpayers are complying with the tax code. If, however, the IRS reduces or changes the way it delivers certain taxpayer services, such action may affect taxpayers' willingness or ability to comply with an increasingly complex tax system.

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[64] RoperASW, *2003 IRS Oversight Board Compliance Study Report*.17 (2003) (cautioning that results may be unreliable given small base of Asian individuals participating in study).

[65] Department of Education, *The State of Literacy in America: Introduction*, *available at* http://www.nifl.gov/reders/!intro.htm (last visited Oct. 15, 2005). The National Adult Literacy Survey classifies literacy into three categories - prose literacy, document literacy, and quantitative literacy. Within each category, an individual's level of literacy is ranked on a scale of one to five, with Level five representing the highest level of literacy and Level one representing the lowest level of literacy.

[66] Department of Education, *The State of Literacy in America: Introduction, available at* http://www.nifl.gov/reders/!intro.htm (last visited Oct. 15, 2005).

Although the impact taxpayer service has on compliance is important, it is not easy to determine. Changes to taxpayer service will affect compliance differently within different demographic groups. Some taxpayers may be forced to use paid preparers or volunteer organizations for assistance. Other taxpayers may simply become noncompliant because they are unable or unwilling to obtain help elsewhere. For those taxpayers who are pushed into noncompliance, this will ultimately result in downstream costs to the IRS in the form of more examinations and collection efforts.

Once it is better informed about the possible effects of changes in taxpayer service on compliance, the IRS can assess whether it is willing to accept a possible reduction in compliance in exchange for altering the channel through which it provides a particular service. For example, if research indicated that a change in how the IRS distributes tax forms and publications might lead to a slight decrease in compliance but would result in a huge cost savings for the IRS, the IRS can determine whether it is willing to make the trade-off of cost reduction in exchange for a lower compliance.

At the moment, however, the IRS has not conducted any serious research on this issue, so it is impossible to determine how any of the recent or proposed changes to taxpayer service will affect compliance.

Migration Strategy

Once the IRS conducts an in-depth taxpayer needs assessment and identifies the effect any changes may have on compliance, the IRS could develop a strategy for implementing changes to the current taxpayer service structure. The IRS cannot simply eliminate certain channels and push taxpayers to alternate channels to receive services. Instead, the IRS must have a comprehensive strategy for migrating taxpayers to different communication channels as well as a plan for providing channels taxpayers *need*.

For a migration strategy to be successful, the IRS must know how effective different communication channels are in delivering services to various groups. The IRS cannot migrate taxpayers to a channel that does not work. If research indicates a channel is not effective, the IRS needs to find out why and how it can fix the channel. Conversely, the IRS needs to ensure that a certain channel is effective before taxpayers are encouraged to use it. Additionally, once the IRS understands what taxpayers need, it may be possible to revamp a lower cost channel to respond to those needs.

The first goal of the migration strategy should be to migrate taxpayers who can be serviced by a lower cost channel to that channel. In determining the number of taxpayers that can be migrated to a low cost channel, the IRS must look first at the group of taxpayers who can be serviced by that channel. Out of that population that can use the channel, the IRS should next look at the subset that will use the channel. This subset is the initial target audience. Although this initial group of taxpayers will likely be easy to migrate – they have indicated both ability and a willingness to use the specific channel – the IRS must also develop a communication strategy to reach these taxpayers. The

IRS should tailor its outreach efforts to make the migration strategy is as effective as possible.

Once the IRS has successfully migrated the initial group of taxpayers to the lower cost channel, the second phase of the migration strategy is to identify by channel and demographic those channels that taxpayers are not willing to use and why they are not used. By understanding why certain taxpayer groups are not using specific channels, the IRS can determine whether it needs to revamp an existing channel or find an alternate method of delivering services. Once the IRS has determined how it will provide services to this second group of taxpayers, the IRS must again develop a targeted outreach strategy. Given the resistance this group of taxpayers may have in migrating to a different channel, research will allow the IRS to craft an outreach strategy to address specific taxpayer concerns. With a targeted outreach message, the IRS may be able to alleviate taxpayers' concerns and convince them to migrate to the lower cost channel they were previously unwilling to use.

It may be that the resistance of several groups to migrate is so great, and the size of the initial, more easily migrated group so small, that it is not feasible or efficient to offer this lower cost channel. That is, the analysis described above may show that the lower cost channel is not, in fact, lower cost after all. The potential for such a result demonstrates the need for research before acting upon cuts to taxpayer service.

What Do We Know Now about Taxpayer Needs and Preferences?

While a taxpayer-centered needs assessment should form the basis of any IRS decisions regarding taxpayer service, such research may take years to complete. The results of the needs assessment should impact not only how the IRS provides taxpayer service, but also how the IRS interacts with taxpayers in all aspects of the tax system. While the impact of this research would be far-reaching, there are steps the IRS can take in the meantime to improve its interaction with taxpayers. The IRS should examine the way in which it is currently doing business and how it is or is not working. Identifying current problems in how the IRS operates may shed light on what might be wrong with current channels and the ways these channels are attempting to communicate information. Additionally, the IRS can begin to identify the downstream costs that can be reduced or eliminated if the IRS simply altered it current practices.

EITC Audit Reconsideration Study

One indication of a problem in how the IRS conducts business is the Taxpayer Advocate Service recent EITC Audit Reconsideration Study. In 2004, TAS, in conjunction with W&I, studied 679 EITC audit reconsideration cases.[67] The study focused on

[67] National Taxpayer Advocate 2004 Annual Report to Congress vol. II. For this study, a random sample of more than 900 EITC cases was reviewed. Ultimately, 679 cases (340 Examination cases and 339 Taxpayer Advocate Service cases) were analyzed in detail for the study. The confidence level for this sample is 95 percent.

identifying ways to improve the accuracy and effectiveness of EITC audit reconsideration and the overall EITC correspondence exam process, while minimizing taxpayer burden.[68]

The study's findings raise questions about how the IRS conducts correspondence examinations and the IRS's reluctance to contact taxpayers via telephone. The study also underscores the importance of improving communication with taxpayers during the initial portion of the audit process. If the IRS can remedy the current lack of communication with taxpayers during the initial audit stage, it could save the downstream costs associated with many audit reconsideration cases.[69] The study also demonstrates the importance of providing taxpayer service within traditional enforcement functions and activities.

EITC Audit Barriers Study

Results from the focus groups conducted as the first phase of the EITC Audit Barriers Study also suggest problems in the way the IRS conducts business. In 2005, the Taxpayer Advocate Service, in conjunction with the EITC Program Office and W&I Research Division, conducted qualitative research into some of the challenges tax examinations pose for low income taxpayers, particularly EITC claimants.[70] The research was designed to determine if EITC eligible taxpayers are adversely impacted by IRS procedures established to reduce EITC overclaims, and if so, what specifically causes the taxpayers' problems.[71]

Two of the areas identified as barriers EITC taxpayers face during IRS exams are related to IRS correspondence and contacting the IRS.[72] The IRS's reliance on correspondence causes problems for many EITC taxpayers, who are unable to understand many of the IRS letters they receive. This observation echoes the finding of the TAS EITC Audit Reconsideration Study and supports the idea that the IRS must reevaluate the way it communicates with taxpayers to better meet their needs and avoid downstream costs.

Focus groups also noted that some EITC taxpayers are more comfortable visiting an IRS walk-in site rather than calling or writing the IRS to resolve a problem. This pref-

[68] For a detailed discussion of the study and its results, *see* National Taxpayer Advocate 2004 Annual Report to Congress vol. II.

[69] National Taxpayer Advocate 2004 Annual Report to Congress vol. II at 40.

[70] Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Tax Clinics* (Sept. 2005). For this study, eight attorneys were interviewed about barriers EITC taxpayers face because of an examination of their tax return. The specific sites were selected based on the number of EITC filers in the area, geographic location, and the proximity of an LITC.

[71] Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Tax Clinics* (Sept. 2005). This research will be used to develop a quantitative study to identify and investigate burdens EITC taxpayers face when their returns are selected for examination. W&I Research, in cooperation with TAS, will design and implement the follow-up study in late 2005.

[72] Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Tax Clinics* (Sept. 2005).

erence stems in part from language barriers and trust issues experienced by some low income taxpayers. Again, this research supports the IRS's need to reevaluate the way it interacts with taxpayers to help them better understand their tax obligations and avoid subsequent problems for taxpayers and costs for the IRS.

The Next Steps

The existing research demonstrates that there is still much we do not know about how best to provide taxpayer service. The IRS should take a number of steps to remedy this situation. In September 2005, the IRS formed the IRS Taxpayer Assistance Blueprint (TAB) team. The team, created in response to concerns raised by the Senate Appropriations Committee,[73] is composed of employees from multiple IRS functions and is responsible for developing a five-year plan to improve taxpayer service. The team is an important first step in recognizing that the IRS needs a long-term strategy for meeting taxpayers' needs.

As part of the five-year plan for taxpayer service, the IRS must engage in a detailed needs assessment, undertaken from the taxpayers' perspective. As discussed above, a clear understanding of what services taxpayers need, and how those services should be delivered to ensure compliance, is critical to any discussion of taxpayer service. Without adequate and reliable research, any changes by the IRS are based on speculation and not on actual taxpayer needs.

While conducting a needs assessment, the IRS should maintain its current level of service. The IRS does not yet know what taxpayers want or need and any changes to the level of taxpayer service are premature. Maintaining current services will also avoid the "gap" period that occurs when old services are discontinued while new services are not yet implemented.

In addition to a needs assessment, the IRS should look at other state and federal agencies to see if anything can be learned from the ways in which they provide services.[74]

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[73] Citing concerns about the IRS's proposed reductions to taxpayer service and inability to explain the impact these changes will have on taxpayers, the Senate Appropriations Committee directed the IRS to:

> … undertake a comprehensive review of its current portfolio of taxpayer services and develop a 5-year plan that outlines the services it should provide to improve services for taxpayers. This plan should detail how it [IRS] plans to meet the service needs on a geographic basis (by State and major metropolitan area), including any proposals to realign existing resources to improve taxpayer access to services, and address how the plan will improve taxpayer service based on reliable data on taxpayer service needs.

S. Rep. No. 109-109, at 133-34 (2005). *See also*, Written Statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service (Apr. 7, 2005).

[74] *See, e.g.*, American Judicature Society, *Courts and the Self-Represented – The Road Ahead, available at* http://www.ajs.org/prose/pro_editorial.asp; National Center for State Courts, *Access to Justice: Meeting the Needs of Self-Represented Litigants (Executive Summary), available at* http://www.ncsconline.org/WC/Publications/Res_ProSe_AccessJustMeetNeedsExecSumPub.pdf; National Center for State Courts, *The Future of Self-Represented Litigation: Report from the March 2005 Summit, available at* http://www.ncsconline.org/WC/Publications/Res_ProSe_FutSelfRepLitfinalPub.pdf.

Any results from other agencies are not IRS-specific and therefore their value admittedly will be somewhat limited. However, the IRS could benefit by identifying a particular service, communication channel, or demographic group, and then examining how other agencies use those service methods to meet the needs of various demographic groups. In this way, the IRS could study alternative approaches and truly develop world class taxpayer service.

IRS COMMENTS

The IRS strongly disagrees with the National Taxpayer Advocate's assessment of our service program for America's taxpayers. In virtually all service areas, our performance and accuracy have improved, even while we are revitalizing our enforcement program. As important, we have continued to respect taxpayer rights as we have rebalanced our service and enforcement program. We are particularly proud that we have sustained these performance levels, notwithstanding the diversion of substantial resources, both human and technical, in order to answer almost one million telephone calls for FEMA as our employees rose to the challenge of assisting taxpayers impacted by this year's devastating hurricane season.

The IRS continually strives to balance service and compliance initiatives while attempting to meet the needs of a wide-ranging taxpayer population amid fiscal limitations. As an organization, we are committed to providing the proper balance between these two complementary activities to ensure continued voluntary compliance and to address the estimated net tax gap, which is between $257 and $298 billion per year as reported in the National Taxpayer Advocate's Most Serious Problem – The Cash Economy.

It is important to recognize that the IRS has been able to obtain these significant improvements in taxpayer service through constantly striving to align more efficient and effective methods of providing services with the evolving needs and preferences of taxpayers. For example, the IRS has --

- Employed advanced call routing technology;
- Developed interactive job aids for our employees;
- Improved our information systems;
- Strengthened our managerial and executive involvement in service delivery;
- Analyzed the tax law changes to determine the impact on our service to walk-in, telephone, and tax assistance customers;
- Expanded service to alternative locations, (such as post offices, federal and state offices, libraries, and community organizations) during the filing season;
- Provided return preparation service using volunteers and Taxpayer Assistance Center (TAC) personnel; and
- Realigned support functions and expanded the use of technology to improve efficiency in pre-filing and outreach efforts.

Aligning service delivery with the services taxpayers use most frequently lets the IRS meet taxpayers' needs while spending their tax dollars more efficiently. Truly noteworthy are our gains in providing information and services via the Internet. Each year has shown solid growth in the number of Internet customers. This year IRS.gov continued to be one of the most visited websites in the world.

Following are responses to particular statements by the National Taxpayer Advocate in her report that are factually incorrect or imply that the IRS has made business decisions exclusively on an interest in increasing enforcement:

Directing Compliance Personnel to Collection Activities during the Filing Season

In May 2003, TAC offices expanded their services to compliance collection work in order to assist taxpayers with a wide range of tax problems. TAC employees work an inventory of Taxpayer Delinquent Account (TDA), Taxpayer Delinquency Investigations (TDI), and high income (over $100,000) non-filer cases. Field Assistance is aware of the importance of balancing taxpayer assistance and compliance work and, as a result, has stressed that collection cases are worked only during the non-filing season (May through December) and never to the detriment of assistance work. In only rare situations, cases in progress prior to the filing season or initiated by the taxpayer may be completed during the filing season.

Declared Disaster Relief Questions Out-of-Scope for Stakeholder Partnerships, Education and Communication (SPEC) personnel

In order to meet the needs created by recent natural disasters, the Katrina Emergency Tax Relief Act of 2005 was enacted and included 11 provisions directed at individual taxpayers. As with all recently issued tax law changes, a determination was made as to which provisions will be in-scope and out-of-scope. SPEC determined that eight provisions were within the scope of the Volunteer Income Tax Assistance/Tax Counseling for the Elderly (VITA/TCE) program, and three (casualty loss, cancellations of indebtedness, and involuntary conversions) were not in scope due to the complexity of the tax law for volunteers.

SPEC recognizes the need to provide some high level training to the VITA/TCE volunteers that will enable them to recognize questions relating to the three out-of-scope provisions. This training, and the new Disaster Services Referral Guide that lists where taxpayers may obtain disaster services, is currently being developed.

Alleged IRS Decision to “dumb down” its Quality Goals

The IRS did not “dumb down” its quality goals for taxpayer service functions to benefit quantity goals for collection, examination, and Criminal Investigation. Achievement of an 89 percent tax law accuracy rate in 2005, up from 82 percent in 2003 and 80% in 2004, took a concentrated effort of managers and employees. The achievement had nothing to do with defining certain calls as being out-of-scope.

The IRS did not "weed out the more difficult questions" from 2003 or 2004 in order to achieve a higher tax law accuracy rate in 2005. Out-of-scope issues have existed since the IRS began offering toll free service over 30 years ago. Highly complex issues, beyond the skill level of assistors, such as tax planning issues, requests for legal advice, and other highly technical questions have always been considered out-of-scope. In the past, however, these issues had not been uniformly or clearly delineated in any written procedural guidance for employees. In order to achieve consistent application of this "unwritten" policy, out-of-scope guidelines were added to the Wage & Investment Accounts Management Program Letter directive and became effective in fiscal year 2006. Therefore, defining out-of-scope questions is not a change in business practice; it is simply clarifying longstanding policy to improve service, consistency, and quality. Implementation of this guidance did not change the level of difficulty relating to in-scope and out-of-scope issues.

Level of Service (footnote 26)

The National Taxpayer Advocate's comments concerning Level of Service are not accurate.

- The FY 2004 Enterprise Snapshot report shows 35.5 million Assistor Calls Answered. The statement that, *"Customer Account Services (CAS) received approximately 40.9 million phone calls directed to telephone assistors in FY 2004."* cannot be verified.
- The statement, *"These are calls relating only to taxpayer service issues, and do not include compliance-related telephone calls"* is incorrect. CAS does receive and answer compliance related telephone calls. The first, third and final collection notices (CP 501/503/504), as well as the annual reminder notices (CP 71s), are compliance notices that contain the CAS telephone numbers. In FY 2005, 56 percent of all notices generated were compliance notices containing the CAS telephone numbers. In FY 2004, 51 percent of notices generated were compliance notices with the CAS telephone numbers.
- The statement that, *"Setting the level of service at 82 percent indicates a decision not to answer 18 percent of phone calls, or approximately 7.4 million taxpayer phone calls"* is an improper conclusion. Setting a Customer Service Representative (CSR) Level of Service goal of 82 percent means that we plan to answer 82 percent of anticipated "call demand" for CSR assistance within a given period of time. There is not a direct one-to-one ratio of callers to call demand because each call attempt does not constitute a unique single customer attempt to receive service during a measured time period. During the measurement period, call demand would consist of all callers who successfully connected as well as those who did not connect and re-dialed and those who received a busy signal and re-dialed multiple times.

Kiosks are Internet-enabled (footnote 31)

The statement that "kiosks are Internet-enabled…" is not correct. IRS kiosks are currently not Internet-enabled, but provide information such as Frequently Asked

Questions, and forms and publications. The Concepts of Operations (CONOPS) describe the future state of Field Assistance and include a scenario of a Virtual TAC that uses kiosks to provide services offered at a traditional TAC. The footnote is presented as the current state of kiosks when it should be the future state.

Strategies to Deliver Taxpayer Service

The IRS does not agree with the National Taxpayer Advocate's inference that it is not assessing service channels or taxpayer service needs and preferences. The IRS already has a strategy team in place.

Over the last five years, the IRS has focused on improving service to individual taxpayers. The IRS Taxpayer Assistance Vision, W&I's Concept of Operations, our Strategic Plans, the "Service + Enforcement = Compliance" equation – all addressed a common theme of improved service. In September 2005, the Taxpayer Assistance Blueprint (TAB) Team was formed to address fundamental questions regarding today's IRS customer and their tax assistance needs from the customer point of view. While TAB builds upon several years of strategic planning efforts, it also addresses a recent Congressional directive to ascertain taxpayer needs and preferences and develop a five year plan to address them. The TAB's project objectives are:

- Develop a credible baseline by assessing current service offerings and delivery channels, and customer needs, behaviors, and preferences across various demographic segments.
- Develop long-term metrics by which the effectiveness of taxpayer assistance can be gauged.
- Develop a repeatable and reliable process that can be institutionalized and integrated into the IRS' existing strategic planning and budgeting processes to ensure the continuous evaluation of taxpayer assistance.
- Develop recommendations and plan for addressing gaps in customer needs and preferences, and evaluate innovative approaches to assistance that will be implemented over the next two to five years.
- Assess the impact of the recommendations on current and future planning, funding, and modernization processes.

The team has outlined the project scope in the context of current IRS business planning and customer service activities and will be using a two phase approach to address the Congressional directive.

Phase 1 will include secondary research, surveys of third-party stakeholders, partners and employees, and blueprint design and development where we will determine customer needs, preferences, and demands and perform a gap analysis of those needs, preferences, and demands. Phase 2 will include additional research, development of an implementation plan for recommendations, integration of recommendations into the budgeting process, and integration of the blueprint into the IRS Strategic Plan.

The IRS will also identify and use leading practices from the private sector, government agencies and international and state tax administration organizations to develop improvements.

To ensure key stakeholders are informed and engaged, a comprehensive stakeholder engagement plan has been developed and is currently being implemented. This plan is being executed to ensure that we have input from customers, employees, intermediaries that either serve or represent taxpayers and oversight bodies.

CONCLUSION

The reality is that the IRS is embracing technological changes, improving accuracy, providing better alternatives to taxpayers, and expanding its scope and services amid more stringent fiscal responsibilities. The IRS recognizes that it cannot provide service to all taxpayers through all channels of its operations. However, current research efforts will identify taxpayer needs, which will allow the IRS to continue to analyze and explore more cost effective means of delivering quality service to taxpayers.

TAXPAYER ADVOCATE SERVICE COMMENTS

Throughout the above discussion on taxpayer service, the National Taxpayer Advocate focused on the IRS's lack of a long-term plan for delivering taxpayer service. This is not to say that the IRS has not made efforts to improve and modernize taxpayer service. In fact, the National Taxpayer Advocate recognizes the improvements the IRS has made to the level of service since 1998; however, these changes to taxpayer service have been made based on what the IRS believes taxpayers want and need, as opposed to what taxpayers indicate they want and need from the IRS.

While "Service + Enforcement = Compliance" is the IRS's working equation that guides many of its actions, the "Service" portion of the equation, including the level of service and types of services offered, remains undefined. Until the recent formation of the Taxpayer Assistance Blueprint (TAB) Team, the IRS has never taken a systematic view of all aspects of taxpayer service to determine how best to meet the needs of all taxpayers. The goal of this piece is to begin a conversation with the IRS on conducting research and developing a taxpayer-focused plan for delivering world-class taxpayer service.

The above discussion lays out issues the IRS should consider as it works to develop a long-term plan for delivering taxpayer service. As one of the parties responsible for developing the five-year plan for taxpayer service, the National Taxpayer Advocate (with the IRS and the IRS Oversight Board), is concerned that the IRS should not act hastily in developing a plan for taxpayer service. Instead, the National Taxpayer Advocate believes the IRS must engage in a research-intensive needs assessment, undertaken from the taxpayers' perspective. This needs assessment will help the IRS identify what services taxpayers need and want, and how best to deliver those services. Additionally, a needs assessment will help identify those groups of taxpayers that may be resistant or unable to access certain services. Once the IRS conducts a detailed needs assessment, and understands how any proposed changes to taxpayer service may affect compliance, the IRS should develop a detailed strategy for migrating taxpayers from the current service model to the proposed model of delivering taxpayer service. In the interim, the National Taxpayer Advocate believes the IRS should maintain the current level of taxpayer service to prevent a "gap" in taxpayer service that may occur if taxpayers are directed towards new service vehicles that are not yet fully capable of responding to taxpayers' needs.

Collection Activities in the TACs during the Filing Season

The IRS states that it will only work collection cases in the Taxpayer Assistance Centers during the non-filing season, except in rare instances. As a general matter, the National Taxpayer Advocate supports providing the full spectrum of assistance in the TACs, including collection and examination case resolution, answering tax law questions, preparing income tax returns, and providing taxpayers with transcripts of their accounts. However, with the reduction of field assistance personnel in the TACs, it is vitally important that all available personnel be dedicated to taxpayer service during the filing season, when deadlines are looming. Contrary to the IRS's statement, its internal guidance states that where there is a conflict between "counter work" and "collection work," the counter can be temporarily closed in order to address the collection matter. This guidance was issued in September 2004, and does not exclude the filing season from its effect.[75]

Declared Disaster Relief Questions Out-of-Scope for SPEC personnel

In its response, the IRS states that it determined that certain disaster-related tax topics "were not in scope due to the complexity of the tax law for [VITA and TCE] volunteers." In our analysis, we did not address issues of disaster questions with respect to volunteers. Rather, we noted that the IRS had determined IRS SPEC employees would not be authorized to answer questions about tax-related disaster relief provisions in conducting outreach and stakeholder relations activities. Since SPEC is the primary outreach function of the IRS for individual taxpayers, we are not clear on who in the IRS will be conducting outreach and education on these important issues, other than TAS.

IRS Toll-Free Level of Service

Contrary to the IRS's statements, in TAS's discussion about the IRS phone level of service, TAS did not refer to the number of "callers" or "taxpayers" calling the IRS. In all of our references to the phone level of service, we referred to "phone calls" and "taxpayer phone calls." TAS derived its level of service calculations for FY 2004 from the Wage and Investment Operating Division's Business Performance Review report dated October 27, 2004, an accompanying PowerPoint presentation produced by W&I, and

[75] IRS, *Field Assistance Collection Work: Questions and Answers* (Sept. 2004).

PROBLEMS

the IRS's Enterprise Telephone Data Warehouse. If W&I's numbers in these reports are incorrect, we stand corrected. The underlying point, however, remains – the IRS is reducing its level of service from previous levels and as a consequence it will either not answer millions of taxpayer calls or force taxpayers to abandon their calls and call again.

RECOMMENDATIONS

The National Taxpayer Advocate looks forward to working with the IRS in developing a strategic plan for delivering taxpayer service that focuses not only on what services taxpayers need, but how best to deliver those services to ensure that all taxpayers receive world-class service from the IRS. In order to achieve this world-class taxpayer service, the National Taxpayer Advocate recommends that the IRS:

- Engage in a detailed needs assessment, from the taxpayers' perspective, as part of the IRS's five-year plan for taxpayer service.
- Identify all of the taxpayer services currently offered and all possible channels of communication for offering these services in order to determine which channel is most effective for delivering the service.
- Develop an understanding of what taxpayers prefer, as well as whether taxpayer preferences can be changed and if there are any limitations on the IRS's ability to change those preferences.
- Examine both internal and external research regarding taxpayer preferences.
- Explore how any changes to taxpayer service will affect compliance.
- Develop a strategy for implementing changes to the current taxpayer service structure, including a plan for migrating taxpayers to different communication channels.
- Maintain the current level of taxpayer service until the completion of the IRS's five-year plan for taxpayer service.
- Examine other state and federal agencies to determine if anything can be learned from the ways in which they provide services.

PROBLEM

TOPIC #2 MOST SERIOUS PROBLEM: CRIMINAL INVESTIGATION REFUND FREEZES

RESPONSIBLE OFFICIAL

Nancy J. Jardini, Chief, Criminal Investigation

DEFINITION OF PROBLEM

The IRS Criminal Investigation Questionable Refund Program (QRP) serves an important tax administration purpose by identifying fraudulent returns, stopping the payment of fraudulent refunds, and referring fraudulent refund schemes to Criminal Investigation (CI) field offices. Each year, the QRP places "freezes" on hundreds of thousands of refunds claimed on individual tax returns because CI believes the returns contain or are likely to contain elements of fraud. Clearly, the QRP helps prevent tax fraud that ultimately steals money from law-abiding taxpayers.

It is no easy task to design a program capable of sorting annually through a large volume of returns and catching enough of the "bad guys" without ensnaring honest taxpayers. As CI officials have repeatedly stressed to us, fraudulent returns and proper returns are often difficult to distinguish on their face. Moreover, the IRS is under pressure from Members of Congress and the Treasury Inspector General for Tax Administration to reduce refund fraud.

Nonetheless, there are significant problems with the QRP as currently designed and administered that we believe the IRS should address quickly.[1] The number of taxpayers whose refund claims are legitimate yet whose refunds are frozen by the IRS is at least in the tens of thousands and quite possibly in the hundreds of thousands each year.[2] CI

1 The National Taxpayer Advocate previously identified CI refund freezes as a problem in her 2003 Annual Report to Congress. In 2003, TAS received about 15,000 frozen-refund cases. In 2005, TAS received more than 28,500 frozen-refund cases.

2 For FY 2004, CI stated that it identified 118,000 fraudulent returns. In addition, CI automatically froze a significant number of refunds in cases where CI had determined fraud to exist in a prior year but had not yet made a determination about current-year fraud. CI does not track how many refund freezes it imposes due to prior-year fraud. However, CI officials have told us that the number of refunds frozen due to prior-year fraud determinations probably exceeds the number of refunds frozen due to current-year fraud determinations. A research study of QRP cases that come to TAS showed that about 36% of the cases involved current-year fraud determinations, about 56% involved freezes imposed due to prior-year fraud, and about 8% reflected temporary freezes imposed to give CI more time to conduct investigations. If the TAS sample is projected to the full universe of CI cases, the result suggests that CI froze 210,000 cases, primarily due to prior-year fraud and secondarily to temporary freezes, for a total of 328,000 frozen returns (118,000 for current-year fraud and 210,000 for prior-year fraud and temporary freezes). In fact, this projection almost certainly understates the number of temporary freezes CI imposes because most temporary freezes are imposed prior to the time a taxpayer would seek assistance from TAS and thus would not be reflected in our numbers. In the TAS sample, taxpayers received a full refund (or more) in 66 percent of all decided cases and a partial refund in an additional 14 percent of decided cases. Taken together, these numbers suggest that the number of refunds improperly frozen could well be in the hundreds of thousands each year. We emphasize that the TAS sample cannot be reliably projected to the full universe of CI cases to reach a firm conclusion on this point. However, the numbers involved are sufficiently high that we believe CI should undertake an immediate review of its own to determine the number of taxpayers entitled to full refunds whose returns are now being frozen. This study should separately assess (1) cases where CI has frozen refunds and determined current-year fraud, (2) cases where CI has frozen refunds based on prior-year fraud, and (3) cases where CI has imposed temporary refund freezes.

does not notify these taxpayers that their refunds have been frozen, and most taxpayers who inquire must wait many months to receive their refunds – often only after the intervention of the Taxpayer Advocate Service (TAS).

In processing year 2005, CI "froze" over 120,000 refunds due to a determination of current-year fraud and CI froze an unknown but probably much greater number of refunds due to its determination of prior-year fraud.[3] During fiscal year 2005, TAS received over 28,000 QRP cases. These cases represent the largest single category of cases in TAS's inventory as well as the highest percentage of cases coming to TAS from any IRS program.

A study of closed TAS cases, presented in Volume II of this Report, shows that the consequences to taxpayers whose refunds are incorrectly frozen are severe. In 66 percent of the decided CI cases in the sample, TAS found no evidence of current-year fraud and the taxpayers ultimately received a full refund (or more) of the amount originally claimed on the taxpayers' returns.[4] Put differently, it appears CI had frozen the refunds of taxpayers fully entitled to receive them in nearly two-thirds of the cases that came to TAS.[5] The median Adjusted Gross Income (AGI) of "no fraud" taxpayers in our study was $13,330, and the median refund received was $3,519. The median AGI of "no fraud" taxpayers who received the Earned Income Tax Credit (EITC) was $11,956, and the median refund received was $3,685. The median cycle time for both categories was 37 weeks, or more than 8 1/2 months. Clearly, the amounts at issue and the lengthy delays cause significant hardship for many of these taxpayers, and the high percentage of "no fraud" findings in the study has important implications for tax administration.

[3] "Processing year" refers to the year in which taxpayers file their returns at the IRS Submission Processing sites. Thus, tax returns processed in a processing year may include returns filed for earlier tax years.

[4] For purposes of the TAS study, we considered a current or prior year return as having an element of fraud if the taxpayer's refund was reduced or reversed while the module was in freeze status. Because CI sometimes identifies fraud after the refund is released, we also considered fraud to be present if the refund was released and CI later placed a freeze on the module during the same calendar year. Thus, the TAS study uses a very broad definition of fraud. Because TAS did not determine the reason why all or part of the refund was disallowed, it is likely that the study overstates the number of cases that have elements of fraud.

[5] We cannot project whether the CI error rate in QRP cases that come to TAS is representative of the CI error rate for all QRP cases. On the one hand, it is certainly possible that taxpayers who choose to pursue their claims are more likely to be entitled to their refunds than taxpayers who do not pursue their claims. On the other hand, TAS conducted a study last year of taxpayers whose EITC claims were denied and sought audit reconsideration. When the IRS contacted these taxpayers to request more information during the original audit, 58 percent responded timely and 42 percent either did not respond or responded after the deadline. Although many research and academic experts who have examined the EITC program had assumed that non-responders and late responders would be less likely to qualify for EITC benefits than taxpayers who timely responded to requests for information, the study showed that both groups qualified at the same rate. This result is not altogether surprising. For EITC taxpayers – many of whom have low education levels, keep limited records, and may be intimidated at the prospect of battling against the IRS – the failure to pursue a claim may reflect nothing more than difficulty in determining how to pursue it. See National Taxpayer Advocate 2004 Annual Report to Congress, Vol. II, *Earned Income Tax Credit (EITC) Audit Reconsideration Study*. The population of taxpayers whose refunds are frozen by the QRP is probably similar. In our sample, about 75 percent of taxpayers whose refunds are frozen claim the EITC and the median adjusted gross income of these taxpayers was under $14,000.

Fraud – in contrast to inadvertent error – is a serious infraction that carries with it significant consequences.[6] Criminal tax fraud can result in monetary penalties or imprisonment, and civil tax fraud can result in a penalty of 75 percent of the tax underpayment.[7] Further, where there is a finding of fraud, the three-year statutory limitations period for assessing additional tax after a return is filed is inapplicable; that is, the IRS may assess additional tax in perpetuity.[8]

Because of the seriousness of fraud, the government generally affords taxpayers an extra measure of protection before making determinations. Indeed, the general rule that the taxpayer bears the burden of proof in tax liability disputes is reversed where the IRS asserts fraud; the government bears the burden of proving fraud in court.[9] Yet despite the serious consequences of a finding of fraud, the IRS often freezes refunds without advising the taxpayer that it has made a determination of fraud, of the reasons for the determination, or of the consequences of that determination. Unless the taxpayer takes the affirmative step of contacting the IRS to inquire about his or her refund, the taxpayer may never know the IRS's position with respect to that return.

One particularly harsh consequence of a QRP determination of fraud is that the taxpayer's refund claims will automatically be frozen until the taxpayer has filed a certain number of consecutive "legitimate" returns (as determined by CI).[10] Considering that a significant majority of taxpayers in our sample whose refunds were frozen were ultimately awarded full relief and that taxpayers are not notified by CI that there has been a finding of fraud, CI's policy to automatically freeze refunds for a certain number of years after a "finding" of fraud imposes a significant burden on large numbers of law-abiding taxpayers and in our view constitutes a fundamental violation of taxpayer rights.

The automatic freeze imposed due to prior-year fraud is also questionable as a matter of policy. We are not aware of any reliable studies that show the look-back period CI currently uses is optimal for detecting future fraud. To the contrary, our study found that in cases where a refund was frozen because of prior-year fraud, taxpayers ultimately received a full refund 79 percent of the time.

Finally, the results of our study suggest that the "revenue protection" benefits of the QRP are somewhat limited. The IRS asserts that for processing year 2004, the QRP identified more than 118,000 fraudulent tax returns and stopped fraudulent refunds

6 For a more detailed discussion of the legal standards and penalties relating to fraud, *see* Volume II of this Report.

7 IRC §§ 7201 & 7206 (criminal sanctions); IRC § 6663 (civil sanctions).

8 IRC § 6501(c)(1).

9 IRC § 7454(a).

10 In stolen identity cases, CI reports that freezes may be released at any time.

totaling more than $2.1 billion.[11] Several elements of these claims warrant comment. First, a single scheme with two tax returns accounted for $1.8 billion of the $2.1 billion total.[12] These huge refunds are not representative of the QRP's historical or overall performance and therefore skew the program's typical results dramatically.[13] Without these two returns, the fraud potentially detected during the 2004 processing year came to about $300 million. Second, CI officials have repeatedly told us that approximately 20 percent of amounts identified by the QRP are paid out prior to the imposition of refund freezes. Again leaving aside the two unusual returns, that reduces the amount potentially protected to about $240 million. Third, CI's statement that these 118,000 returns are "fraudulent" reflects simply its own initial assessment to that effect. Among taxpayers whose returns CI deemed "fraudulent" and who then sought assistance from TAS, CI ultimately agreed that the taxpayers were entitled to a full refund in a significant percentage of the cases.[14] Thus, even the remaining $240 million deemed "protected" is probably a significant overstatement. Rather, it appears that the measurable revenue gains of the QRP are limited after taking into account the resources devoted to the program by CI, TAS and the IRS Examination function – which is required to forego higher dollar cases to handle some low-dollar CI QRP referrals – plus the amount of interest the IRS pays out on improperly frozen refunds.

An analysis of decided frozen-refund cases in our study shows that 158 percent of the dollars frozen by the QRP was ultimately and correctly paid out. The amount the IRS froze in our sample was $1,551,574, yet the IRS ultimately paid out to these taxpayers

[11] *See* Hearing before the Senate Committee on Finance on the Tax Gap, 109th Cong. (April 14, 2005) (statement of Nancy J. Jardini, Chief, IRS Criminal Investigation) ("During processing year 2004 CI reviewed nearly 500,000 questionable refund returns. Of those, they identified more than 118,000 fraudulent tax returns and stopped fraudulent refunds totaling more than $2.1 billion."); *see also Hearing before the House Ways and Means Subcommittee on Oversight on Prisoner Fraud*, 109th Cong. (June 29, 2005) (statement of Nancy J. Jardini, Chief, IRS Criminal Investigation) (making essentially the same statement).

[12] *See* Hearing before the House Ways and Means Subcommittee on Oversight on Prisoner Fraud, 109th Cong. (June 29, 2005) (statement of Nancy J. Jardini, Chief, IRS Criminal Investigation) (stating that the overall 2004 estimate includes one scheme with two tax returns totaling $1.8 billion).

[13] To provide perspective, an Inspector General's study of the QRP for the January through September period in 1999 (during which substantially all 1998 refund claims were filed) noted that the QRP detected about $108 million in fraudulent refund claims. *See* Treasury Inspector General for Tax Administration, Ref. No. 2001-40-025, *Revised Questionable Refund Program Procedures Were Not Consistently Implemented* (Jan. 2001).

[14] As noted elsewhere in this discussion, CI ultimately agreed that the taxpayers were entitled to a full refund in about two-thirds of all decided cases in our sample and to full or partial refunds in 80 percent of the decided cases in our sample. For purposes of its "revenue protection" estimates, however, CI told us that it only includes cases that it has determined to be fraudulent in the current year – not cases flagged solely because of a prior-year fraud determination. In the sample of cases we examined, we identified 171 returns in which we believe potential fraud was detected for the first time (*i.e.*, the returns were placed into "Z freeze" status yet there was no history of "Z freezes" in prior years). Of these 171 returns, 65 resulted in full refunds, and 29 were still undecided. Thus, it appears that in about 46 percent of the decided cases in our sample where CI had determined that taxpayers had submitted fraudulent returns and included the taxpayers and the dollars frozen in its "revenue protection" estimate, CI ultimately agreed that the taxpayers were entitled to receive the full amount of the refunds they claimed on their original returns.

$2,457,309, including interest of over $81,000.[15]

Notwithstanding the important tax administration purpose served by the QRP, the TAS study results suggest several significant problems with the program:

- CI's fraud detection methods are not as effective as they should be at screening out non-fraudulent refund claims, and therefore cause undue burden for a significant number of taxpayers.
- CI generally does not notify taxpayers that their returns are frozen as fraudulent or provide them with the reasons for such freezes. Thus, taxpayers are not given an opportunity to substantiate their claims or to show that any overclaims identified were due to honest error rather than to fraud.
- Current IRS procedures subject QRP returns to inordinate delays. If a taxpayer subject to a QRP freeze contacts the IRS, IRS employees, including TAS employees, are generally prohibited from providing any information to the taxpayer for 180 days (or six months) from the date the taxpayer first contacted the IRS to inquire about the delayed refund.
- Where the IRS detects fraud on a taxpayer's return, the IRS *automatically* freezes future refund claims of the taxpayer until the taxpayer files a certain number of "legitimate" returns (as determined by CI), even though the initial IRS determinations of fraud are often incorrect and even though there is little evidence that a taxpayer is particularly likely to repeat refund fraud after he or she is identified and deterred in the initial attempt.
- In many cases, refund returns of taxpayers who are victims of identity theft are *automatically* classified as fraudulent for successive years. These identity theft victims are subject to both the delays inherent in the QRP process and the delays caused by the need to demonstrate for each successive year that they are in fact the victims and not the perpetrators.
- CI does not have the resources to investigate all of the refunds it freezes in a timely manner. Thus, some refund cases are left in permanent "freeze" status for long periods of time without being referred to the IRS Examination function for determination of the correct tax due.
- Other IRS functions, especially Examination, do not have the resources to effectively deal with the spill-over effect from the large number of CI refund freezes without detracting from their ability to address higher priority cases. The large number of freezes creates problems for both taxpayers and the IRS. When Examination does not work a case and no notice of deficiency is issued, taxpayers are placed in the position of having to sue in a United States district court or the

[15] The overall refund amount in the sample includes a single refund of $1,359,175. It is possible that this refund renders the overall result unrepresentative of overall cases. Even if we exclude this refund, however, 71 percent of the dollars frozen in the sample ($1,098,134) was ultimately and correctly paid out.

United States Court of Federal Claims to obtain their refunds.[16] Low and middle income taxpayers may not be able to afford to litigate and thus would remain in limbo in the IRS. From an IRS standpoint, Examination is forced to work a significant number of low-dollar QRP cases when it could probably do more to close the tax gap if it devoted its limited resources to higher dollar cases.

ANALYSIS OF PROBLEM

IRS Criminal Investigation and the Questionable Refund Program

Criminal Investigation (CI) is the law enforcement arm of the IRS and is responsible for investigating tax-related crimes. CI's primary investigatory focus is "Legal Source Investigations," which are investigations of intentional violations of the Federal tax laws by taxpayers who have legally earned income.[17] The Legal Source Tax Crimes Program includes the Questionable Refund Program (QRP).[18]

The QRP is a nationwide multifunctional program established in January 1977 and is an important part of the IRS's overall Revenue Protection Strategy.[19] The QRP was designed to identify fraudulent returns, stop the payment of fraudulent refunds, and refer identified fraudulent refund schemes to CI field offices.[20] It principally uses data-mining software to analyze the tax return information submitted by taxpayers seeking refunds, although other methods of fraud detection are used as well.[21] When QRP data-mining identifies certain taxpayer-specific information, the system delays the issuance of a refund for one week. If CI does not validate the taxpayer's entitlement to the refund after a week, it may place the refund request into a "freeze" status so that the refund is not issued until the IRS assures itself that no fraud is present. QRP schemes

16 For a more detailed discussion of the refund claim and refund suit procedures, *see* Volume II of this Report.

17 IRS Pub. 55B, *Data Book, FY 2003*, (rev. 3-2004), Table 18, 52; *see also* IRM § 9.5.3.2.1.

18 CI also maintains the Return Preparer Program (RPP), which attempts to identify returns prepared by tax return preparers who engage in tax fraud. IRM § 9.5.3.2.6. Because the vast majority of frozen refunds are frozen through the QRP, this analysis focuses primarily on the QRP. For FY 2004, CI determined that 118,075 refunds were deemed fraudulent through the QRP, as compared with 2,426 in the RPP. Over a recent 3-month period, only 35 cases of the approximately 3,436 new CI refund freeze cases in TAS were related to the RPP.

19 The IRS Revenue Protection Strategy consists of four elements:
- Understanding Fraud: Knowledge of the Revenue Protection Strategy and its relationship to the overall mission of the IRS;
- Prevention: Outreach and education efforts to ensure that taxpayers understand how, when and where to file complete and accurate returns;
- Detection: Identification of areas that must be protected against fraud and abuse before refunds are paid; and
- Enforcement: A combination of criminal prosecution and other enforcement initiatives.

Hearing Before the House Appropriations Subcommittee on Treasury, Postal Service & General Government, 103rd Cong. (March 12, 1996) (statement of Donald K. Vogel, Assistant Commissioner for Criminal Investigation, Internal Revenue Service).

20 *Id.*

21 In processing year 2004, CI screened more than 100 million refund returns through data-mining software. Criminal Investigation, *Presentation to the Taxpayer Advocate on the Questionable Refund Program* (March 2005).

are also detected through communications from electronic return originators (EROs), financial institutions, return preparers, and concerned citizens.[22] The QRP is operated out of CI's ten Fraud Detection Centers (FDCs), which are co-located with the IRS's ten campuses.

When a taxpayer comes to TAS complaining of refund delays and TAS verifies that CI has frozen the refund, TAS must seek permission from CI to provide information to the taxpayer. TAS will then work with the taxpayer to obtain documentation that substantiates the refund claim. TAS cannot obtain any refund relief for a taxpayer unless CI concurs in the result.

Study of TAS QRP Cases

For the last two years, TAS received more cases involving CI refund freezes than any other issue in its case inventory. Over the last four years, the TAS volume of CI cases has increased by over 400 percent.

TABLE 1.2.1, TAS'S CI CASE INVENTORY FOR FY 2002 THROUGH FY 2005[23]

Fiscal Year	Receipts	Closures
2002	5,509	5,295
2003	15,118	15,145
2004	16,460	12,741
2005	28,639	26,505

For FY 2005, TAS records indicate that out of 26,206 closed CI QRP refund cases, taxpayers received "full relief" in 14,658 cases (56 percent) and "partial relief" in an additional 1,050 cases (4 percent).

The large number of CI cases in TAS's inventory and the high incidence of full relief in these cases led TAS to undertake a study of a statistically representative sample of its CI refund freeze cases. The goals of the study were to determine (1) the accuracy of TAS's own inventory results (*i.e.*, did TAS case outcomes, as recorded on its databases, accurately reflect what occurred in the cases?); (2) the accuracy of the QRP in identifying and freezing cases involving actual fraud; and (3) the impact of the QRP program

[22] IRS Criminal Investigation *FY 2000 National Operations Annual Report* 33; *see* IRM § 9.5.3.2.2.2 (Sources of Refund Fraud Investigations).

[23] Virtually all of the CI cases received by TAS relate to QRP refund freezes. However, the statistics for years prior to FY 2005 include all CI-controlled cases received by TAS, and a very small number related to other issues. Beginning in FY 2005, TAS began to track refund-freeze cases separately, so the numbers in this chart reflect exclusively QRP and Return Preparer Program (RPP) cases. In FY 2005, there were 26,318 QRP cases and 187 RPP cases. (In FY 2005, there were 26,206 cases excluding 112 cases coded as Criteria 9 - the Local Taxpayer Advocate has determined it is in the best inerest of the taxpayer for TAS to be involved).

on taxpayers.[24]

TAS analyzed a sample of 473 cases from closed TAMIS (Taxpayer Advocate Management Information System) inventory from FY 2004 through the first six months of FY 2005.[25] Although some cases in the sample involved multiple tax years, the study focused only on the most recent tax year at issue. Notwithstanding the focus on the most current year, the study took into consideration CI's policy of freezing refund claims filed by taxpayers who CI believes submitted false claims in the recent past. The researchers considered the taxpayers' filing histories and attempted to identify taxpayers who had a "Z freeze" placed on refunds within the recent past that would cause an automatic freeze to be imposed for the current year.[26] A "Z freeze" is a transaction code used to show CI's determination that the refund claim is fraudulent or to indicate that CI made a prior-year determination of fraud with respect to that taxpayer. In both situations, the Z freeze blocks the issuance of a refund.

The study used two methods of collecting information. Primarily, senior TAS research staff retrieved and analyzed data from the IRS Master File data system. Secondarily, TAS and CI personnel performed a manual review of the cases, collecting information from various tax databases and reviewing multiple years of data on each taxpayer in the sample. Because the latter method relied to some extent on the subjective judgments of the individual reviewers, the TAS-CI study is based almost exclusively on the information and analysis provided and analyzed by the TAS research staff.[27]

TAS applied the following definitions to identify the presence or absence of fraud:

- *No Fraud:* For both current and prior-year tax periods, fraud was not considered to be present if the taxpayer received a *full* refund after the tax module had been placed in freeze status (i.e., the refund issued must have equaled or exceeded the amount claimed on the original return).
- *Fraud:* For both current and prior-year tax periods, fraud was considered to be present if the taxpayer's refund was reduced or reversed while the module was in

[24] The full results of the TAS-CI Frozen Refund Study are set forth in Volume II of this Report.

[25] A sample size of at least 384 cases was required to obtain a 95 percent confidence level in the results of the review. A 95 percent confidence level means that conclusions with respect to the sample have a 95 percent likelihood of being applicable to the population from which the sample was drawn. Originally, 500 cases were selected for the study. Twenty-seven of those cases were subsequently removed from the sample because they did not fall within the sample parameters (*i.e.*, they involved closed TAS-CI cases with frozen refunds) or because of lack of available data.

[26] Data were extracted from the Compliance Research Information Tracking System (CRITS). CRITS extracts the requested data elements for the specified taxpayer identifying numbers (TINs) from the on-line Master File. Because of the relationship between the limited number of past years for which CRITS data are available and the number of years for which IRS freezes refund claims based on its finding of prior-year fraud, TAS could not conclusively determine the full applicability of the look-back rule for the earliest tax years potentially involved.

[27] While the TAS research staff used Master File data, the staff also compared the results of the Master File analysis to the results of the manual review in order to identify and resolve any discrepancies between the two approaches.

freeze status. Since CI sometimes identifies fraud after a refund is released, we also considered fraud to be present if a full refund was released but a freeze was later placed on the module during the same calendar year.

- *Undecided:* For both current and prior-year tax periods, we treated a case as undecided if we found no indication that the refund claimed on the return was reduced or reversed but also found no indication that a refund had been issued. These cases appeared not to have been worked to completion.

We want to emphasize that our decision to treat all cases in which the taxpayer received less than a full refund as "fraud" cases was designed to avoid the possibility of understating the amount of fraud. In reality, many if not most overclaims by taxpayers are attributable not to fraud but rather to honest errors or, in some cases, negligence. Thus, the actual rate of fraud is undoubtedly lower than the results of our study suggest.

TAS CI QRP Study Results

Out of our sample of 473 TAS cases, 398 cases were decided at the time the study was conducted, and TAS found no evidence of current-year fraud in 66 percent, or 263, of the decided cases. In these 263 cases, taxpayers ultimately received the full amount – or more – of their originally claimed refunds. In an additional 14 percent, or 57, of the decided cases, taxpayers received a partial refund. Thus, taxpayers received full or partial refunds in fully 80 percent of the decided cases in our sample (320 out of 398 decided cases).[28]

The median cycle time, measured from the week the return posted to the IRS Master File to the week the refund was released, was 37 weeks, or 259 days (more than 8 1/2 months).

TAS identified 135 cases in the study where there appeared to be some indicia of fraud. Of those 135 cases, only 29 clearly involved instances of repeat fraud.[29]

In 75 of the cases in the sample, CI appeared not to have worked the case to completion at the time TAS began its study and TAS therefore was unable to determine whether fraud was present based on the Master File data. In a subsequent manual review of these cases, we discovered that some of these cases were worked to completion

[28] As noted above, a sample size of 384 cases was required to obtain a 95 percent confidence level in the results of our study. The number of decided cases in the sample was 398. Therefore, our sample size of decided cases is large enough to permit analysis within the established parameters of statistical reliability.

[29] In 25 of those 29 cases, the taxpayer had already received a refund and was probably unaware that CI subsequently detected possible fraud. Significantly, the study results show that when taxpayers were clearly aware that the IRS suspected fraud, very few taxpayers committed fraud in future years.

after our initial extract.[30]

TABLE 1.2.2, PRESENCE OR ABSENCE OF FRAUD IN FULL TAS SAMPLE[31]

Type of Refund Relief	Number of Cases within Full Sample	Percentage of Full Sample
No Fraud	263	56%
Fraud	135	29%
Undecided	75	16%
Totals:	473	100%

TAS determined that the median Adjusted Gross Income (AGI) of returns in the study was $12,849 and that 90 percent of the taxpayers had AGIs of $34,792 or less.

More than 74 percent of the taxpayers in the total sample (352 taxpayers) claimed the Earned Income Tax Credit (EITC), and 294 of the EITC cases have been finally decided. Of the taxpayers in those cases, 66 percent (193) received full refund relief. We determined that 116 of the 193 taxpayers who ultimately received their full refunds (60 percent) had had their refunds frozen because of a determination of fraud by CI in a prior year.

Twenty-seven cases in the sample involved identity theft, covering 55 refund modules (or periods). The IRS froze 30 of these 55 modules after it had already had a full year to resolve the identity theft case.

CI initially placed $1,551,574 in freeze status among the decided cases in our sample. However, the IRS ultimately paid out $2,457,309, including interest of over $81,000, to 320 taxpayers in the sample. Thus, the IRS actually paid out $905,735 more than taxpayers had claimed on their original returns.[32]

Implications of TAS-CI QRP Study

In principle, the refund freeze process is necessary from a tax administration standpoint for several reasons. First, returns selected through data-mining show some indication that there may be a problem with a refund request, and it is important that the IRS protect revenue while it evaluates these concerns. The Treasury pays out hundreds of

30 In these 75 cases, as of the time TAS researchers first reviewed the sample, the IRS had not yet made any adjustments to the refunds and had not yet made any referrals of these cases to the Examination function. Of the 75 cases, 19 involved tax year 2002 and had been in frozen status for two years without any action being taken, while 47 of the cases involved tax year 2003 and thus had been frozen for at least one year without any adjustments or referrals to Examination taking place. TAS researchers have since reexamined these 75 cases and found that the IRS has taken action on 20 of these cases, giving full refund relief to 15 of the taxpayers and denying full refund relief to five of the taxpayers.

31 These percentages add to more than 100 percent due to rounding.

32 *See* note 14, *supra.*

billions of dollars in refunds annually.[33] This volume of dollars presents opportunities for some measure of fraud.[34] Second, validating a refund request requires a policy decision: Should the IRS pay out the refund first and try to recoup the tax later if the taxpayer is not entitled to the refund, or should the IRS freeze the refund until the return can be validated? In most instances, it is difficult and costly for the IRS to recoup refunds already paid to persons who are committing fraud.

Thus, we share the IRS's premise that the balance of interests necessitates an initial freeze on questionable refunds. However, fairness and due process considerations require that the IRS put in place adequate procedures to minimize the harm to non-fraudulent taxpayers and to bring all frozen refunds to final resolution in a prompt manner. There are several specific problems related to the QRP program as currently administered that have a negative impact on taxpayers and on the IRS.

CI Fraud Detection Methods Do Not Effectively Screen Out Non-fraudulent Refund Claims

Fraud detection methods, such as data mining, allow CI to easily search and freeze significantly more refund claims than in the past. However, the ability of CI to manage its caseload has not kept pace with the growing number of freezes.[35] In light of the increasing volume of CI refund freezes and our finding that significant numbers of refunds are incorrectly classified as fraudulent, CI should consider reevaluating and recalibrating its freeze criteria and introducing additional screens and other artificial intelligence techniques as well as speedier and more accurate reviews by CI employees. A recent TAS case demonstrates the need for CI to pay close attention to refund freeze criteria.

> **Example:** CI developed a scheme detection program to identify and freeze EITC refunds on returns that report income from employers with foreign addresses. Pursuant to IRC § 32(c), taxpayers with foreign-source income are not eligible for the EITC. A large United States employer had utilized a foreign post office box over 35 years ago but had long since changed its address to within the United States. A computer system mistakenly retrieved the 35-year-old obsolete mailing address and automatically froze the refund claims of over 2,300 of the company's employees. When taxpayers began complaining to TAS, the Local Taxpayer Advocate co-located with the relevant Fraud Detection Center (FDC) worked out a systemic release of the refunds

[33] For FY 2004, the Treasury Department paid out more than $227 billion in refunds to individual taxpayers. IRS Data Book, FY 2004, Publication 55B (rev. 3-2005), Table 1.

[34] For example, representatives from CI provided examples of fraudulent returns with fake Forms W-2 that were of excellent quality.

[35] CI has told us that the use of data mining has resulted in a 73 percent reduction in workload and a 55 percent increase in fraudulent returns identified. These statistics are commendable on their face, but in light of the significant percentage of refunds frozen where no fraud exists and the lengthy delays taxpayers experience as a result of the large number of freezes that require employee work, these statistics do not necessarily demonstrate that the fraud detection process has improved overall.

> with the Resident Agent in Charge of the FDC. Significantly, however, the refunds of these 2,300 taxpayers were delayed due to, in essence, a computer error, and CI did not identify or correct the problem until TAS began to receive taxpayer complaints and asked CI to address them.

CI also lacks adequate data to evaluate the effectiveness of its data-mining criteria or procedures. For example, CI does not know how many temporary freezes (P freezes) it places on accounts. It does not know the percentage of P freezes that become Z freezes or the percentage of P freezes that result in released refunds.[36] It does not know how many Z freezes it places on refunds due to prior-year fraud. It does not know how many "resequenced" cases it reviews in the one-week review period following initial receipt and identification of flagged refund claims. It does not know the percentages of cases it freezes that receive full relief, partial relief, or no relief. CI needs this kind of information to evaluate the effectiveness of its fraud detection methods, particularly data mining, and other IRS functions need this information to plan for the downstream effects of CI's refund freezes. In addition, this kind of information might help CI refine its data-mining criteria.

It may be that the QRP data-mining criteria are as good as they can be. If this is the best that the software can do, then it is all the more incumbent on the IRS to make sure its processes promptly identify potentially *non-fraudulent* frozen refunds. The IRS must immediately notify these taxpayers and provide them with an accessible avenue for challenging CI's assertions.

Current IRS Procedures Subject QRP Taxpayers to Inordinate Delay

IRS procedures do not allow a taxpayer with a CI freeze code on his or her account to be given information about the freeze by any part of the IRS, including TAS, until 180 days have elapsed from the date of the taxpayer's initial contact with the IRS.[37] Because of its high volume of cases, CI cannot always make a determination on a case within 180 days. This delay results in taxpayers' returning to TAS after the 180-day period expires and in TAS's reopening closed cases. Moreover, it is likely that some taxpayers with legitimate refund claims do not continue to pursue their refund claims

[36] In order to prevent questionable refunds from being automatically issued, CI delays – or "resequences" – these claims for one week so that it can determine whether it should freeze the claims. CI routes cases through a verification process designed to validate the taxpayer's reported income and withholding. Here, CI either releases the refund or freezes the case under one of two codes. A "Z freeze" indicates that CI views the refund claim as fraudulent and is viewed as a permanent freeze. A "P Freeze" is a temporary freeze that allows the IRS to perform further investigation of the refund claim. A P freeze indicates that CI was unable to review the refund claim during the one-week period allotted by resequencing.

[37] IRM § 13.1.10.9. An exception exists for TAS economic hardship cases. For a description of the exception, *see* Service Level Agreement Between The National Taxpayer Advocate And The Chief, Criminal Investigation (effective June 1, 2005).

and do not return to TAS.[38] Even after expiration of the 180-day period, CI may designate a case as a "no contact" case, which means that TAS is not permitted to provide account information to the taxpayer.[39]

CI established the 180-day period to enable it to investigate frozen refund claims. As noted, however, the 180-day period begins on the date the taxpayer *contacts* the IRS rather than on the date CI freezes the taxpayer's account. Thus, CI may place a case in a temporary freeze status where it can sit for 180 days or more until a taxpayer calls and is told that he or she must then wait another 180 days. When TAS contacts CI after expiration of the 180 days, we often find that CI has not investigated the case. Moreover, Local Taxpayer Advocates have reported cases where taxpayers have been told to wait 180 days so that the IRS can complete its review – only to be told when they call back 180 days later that the case has been referred to Examination and that they must wait another 180 days for Examination to complete its review. Finally, the 180-day delay period causes "re-work" for other IRS functions, which must tell the taxpayer to come back another time rather than deal with the taxpayer at the time of initial contact.

The following steps might give CI a reasonable period of time to investigate cases while protecting taxpayer rights:

- Limit the no-contact delay period to 60 or 90 days;
- Begin counting this period from the return-receipt date or the freeze date rather than from the taxpayer-contact date; and
- Develop expedited procedures for certain circumstances, including economic hardship, EITC, and identity theft cases.

IRS Generally Does Not Notify Taxpayers That Their Refunds Are Frozen or About the Reasons for the Freeze

Although CI freezes hundreds of thousands of refunds, it does not notify taxpayers that their refunds have been frozen. Thus, taxpayers do not have an opportunity to present documentation to support their refund claims until *after* CI has made a determination of fraud, if at all. CI's procedures also complicate the efforts of other functions within the IRS, such as Accounts Management (which handles the toll-free customer service lines) and TAS, to answer taxpayer questions about CI refund freezes. For example, as noted above, TAS initially is not permitted to inform the taxpayer about the freeze on the refund or any action that the taxpayer may be able to take to expedite a refund release.[40]

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[38] For a detailed discussion about the types of and reasons for noncompliance, *see* Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003). Professor Book draws largely from the social science perspective offered by Professors Robert Kidder and Craig McEwen. *See* Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance* and Noncompliance, 2 Taxpayer Compliance 47 (1989).

[39] IRM § 13.1.10.9(5).

[40] IRM § 13.1.10.9(1).

When the IRS cannot communicate with taxpayers who are calling about their refunds, CI and the IRS are missing an important opportunity to move the case along. Communication encourages taxpayers making legitimate refund claims to substantiate their claims, puts the IRS on notice that it has possibly frozen a non-fraudulent claim, and demonstrates to fraudulent taxpayers that the IRS is looking at their returns and may take action.

In March of 2005, certain CI Fraud Detection Centers (FDCs) began issuing letters to some taxpayers in response to the taxpayers' inquiries about their delayed refunds. The letters advise the taxpayer that a problem with the return has been identified, invite the taxpayer to provide additional information to substantiate the refund claim, and indicate that falsifying refund claims is a crime. These letters are a positive development. However, not all FDCs send the letters, and some FDCs that did send them initially have stopped doing so, opting to give TAS language to utilize in its own letter.[41] A recent survey of Local Taxpayer Advocates indicates that four out of ten FDCs do not send the letters at all, while the other six send the letters only in some cases.[42] Additionally, these letters are not standardized, as CI has not placed them on the IRS Correspondex system.[43] Thus, some similarly situated taxpayers are receiving different letters, while others are receiving no letters at all.[44]

We recommend that all CI FDCs provide letters to taxpayers whose refunds are frozen by CI. In appropriate cases, notices should be sent at two points in the process:

- When CI temporarily freezes a refund, the letter should include an indication of how much delay the taxpayer might expect.
- When CI has determined not to issue a refund, the letter should include an explanation and a description of the taxpayer's procedural rights to challenge the claim disallowance, including access to TAS.

IRS data systems should reflect when these notices are sent so that other IRS functions

[41] Effective June 1, 2005, CI and TAS entered into a Service Level Agreement (SLA) which sets forth procedures governing how cases will be worked. The SLA also provides that either CI will send the letter when the taxpayer inquires about a frozen refund or CI will provide language to TAS so that TAS can send the letter.

[42] Of the six FDCs that send the letter, one FDC sends the letters only on Z freeze cases (i.e., when the IRS has made a final determination on the case), but not when the case is still in P freeze (temporary freeze) status. Another FDC sends the letter in some but not all circumstances, such as when the case is being referred to Examination.

[43] Correspondex is the IRS's correspondence system. Use of Correspondex ensures that IRS letters are evaluated for tone, clarity and content.

[44] Current refund-freeze procedures contrast sharply with the description of QRP procedures provided by then-IRS Commissioner Margaret Milner Richardson in 1996:

> When we have delayed a refund in whole or part, we are letting taxpayers know why. Our notice explains that the full refund or remaining refund will be sent within eight weeks unless we determine additional contact with the taxpayer is necessary to verify the claim.

Fiscal Year 1996 IRS Budget Request, Hearing Before the House Ways and Means Committee, 103rd Cong. (Feb. 27, 1996).

are aware of the status of the case if the taxpayer calls in response to the letter.

CI's Policy of Freezing Refunds Automatically For a Certain Number of Years After It "Determines" the Presence of Fraud on a Refund Claim Is Harming Too Many Law-Abiding Taxpayers

When CI determines fraud is present on a refund claim and places a Z freeze on the account, it automatically places a Z freeze on future refund claims until the taxpayer files a certain number of returns that CI deems legitimate. This policy negatively impacts taxpayers by subjecting them to the refund freeze process without regard to likely changes in their behavior. The policy is not based on statistical evidence that fraud is likely to recur within the specified number of years after fraud is found in an earlier year. Instead, the policy seems to be based on a generalized assumption that a taxpayer who has committed refund fraud is likely to repeat the fraudulent behavior in future years.

Given that a significant majority of taxpayers whose refunds were frozen were ultimately awarded full relief in our sample and that CI generally does not notify taxpayers that there has been a finding of fraud, the automatic freeze in future years is harsh and in our view reflects an absence of adequate taxpayer protections. In fact, among the decided cases in the TAS-CI study in which we could determine conclusively that there was a CI finding of prior-year fraud, 79 percent of the taxpayers (149 out of 189) ultimately received a full refund for the year at issue.

The burden on the IRS as a result of this policy is significant. Every year, the QRP freezes more cases because of both the volume generated by its annual data-mining and its policy of freezing anew any return placed into Z freeze status in the recent past. Moreover, the policy burdens other IRS functions – including Accounts Management and TAS – because they must handle increasing numbers of cases for which they did not plan.

We recommend that CI study the effects of its Z freeze procedures to determine what the optimum number of automatic freezes should be, if any. CI should consider developing "prior fraud" criteria based on sound research into the correlation of prior-year refund fraud and current-year fraud. The study should separately consider the likelihood of recurrent fraud where (1) the taxpayer has been put on notice that the IRS suspected fraud in a prior year and (2) the taxpayer has no reason to believe that the IRS suspected prior-year fraud.

CI Policy to Freeze Refund Claims Filed by Identity Theft Victims Automatically Is Overly Broad and Causes Significant and Continuing Inconvenience to Identity Theft Victims

The refund freeze process does not provide an adequate procedure to manually remove certain taxpayers once they are identified as compliant. Certain fact patterns will automatically generate a Z freeze each year, regardless of whether a prior-year return with identical circumstances was resolved in the taxpayer's favor. For example, when CI determines that two people have used the same Social Security Number (SSN) on different tax returns, it automatically enters a Z freeze on both taxpayers' returns. With the prevalence of identify theft, this situation is more common than in the past.[45] Although CI tells us that freezes in stolen identity cases may be released at any time, our experience indicates that CI often freezes refunds of the taxpayers involved year after year, even when the victim has been clearly identified. Thus, an honest taxpayer faces significant delays and burdens, in addition to the other problems associated with identity theft, to obtain his or her rightful refund.

In 27 cases reviewed in the TAS-CI study (six percent of the full sample), the taxpayers were victims of identity theft. In one case, the taxpayer fully expected that she would have to return to TAS each year to assist in a release of the refund freeze even though the IRS had long since identified this taxpayer as the rightful owner of the SSN. Other taxpayers in the TAS-CI study had Z freezes placed on their previous six or seven years' tax returns even though the IRS ultimately found no reason to have withheld any portion of the refunds claimed in any of those years.

The issue of identity theft – and the problems the IRS faces in trying to address it systemically without placing greater burdens on the innocent taxpayer – reaches far beyond QRP refund freezes.[46] In fact, we believe that a true fix for the QRP will require an IRS-wide system that identifies and notates which taxpayer is the victim. In the short term, however, we recommend that CI develop a method for identifying and screening out certain SSNs and names from the freeze process so that it does not harm taxpayers who have previously proven that their identities were stolen.

CI Lacks Adequate Resources to Promptly Investigate All Frozen Refund Claims

Once CI identifies a potentially fraudulent refund claim, it has one week to complete a verification process designed to validate the taxpayer's reported income and withholding. Due to the high volume of cases, there is often insufficient time within the allotted week to verify all cases. Refund claims not verified during the one-week process are designated with a P freeze (*i.e.*, a temporary hold status).

In the post-verification stage, CI personnel are supposed to review the refund claims designated with P freezes that CI was unable to review in the verification process. The IRS releases frozen refunds if CI determines that a Z freeze is not warranted; however, the imposition of a Z freeze places the account in a permanent freeze status unless and

[45] Identity theft is increasingly common throughout the United States, with 500,000 to 700,000 people becoming victims every year. *Identity Theft: The Nation's Fastest Growing Crime Wave Hits Seniors*, Hearing Before the Senate Special Committee on Aging, 107th Cong. (2002) (statement of Alice S. Fisher, Deputy Assistant Attorney General, Department of Justice Criminal Division).

[46] For a more detailed discussion of the IRS challenges in dealing with identity theft, *see* Most Serious Problem: *Identity Theft, infra*.

until CI releases the freeze.

Once a case is designated with a Z freeze code, it may be referred to the Examination function for a correspondence audit.[47] CI refers cases to the Examination function electronically in bulk twice a year.[48] Once a case is accepted, Examination is required to log it onto the Audit Information Management System (AIMS) database so that other IRS personnel can determine which Examination office has responsibility for the audit.

However, CI does not refer many, perhaps most, refund freezes to Examination for final resolution. In processing year 2004, for example, CI reported that it identified more than 118,000 fraudulent returns, and it imposed freezes due to prior-year fraud and temporary freezes on perhaps 210,000 additional returns. For this same period, the Examination function indicated that CI referred approximately 56,000 cases for audit. Thus, the majority of returns were not referred to the Examination function for final disposition. If a case is not referred to Examination or is rejected by Examination because it does not meet referral criteria, the case remains in Z freeze status and the taxpayer may never be told of either the fact that the refund has been frozen or the reasons therefor unless the taxpayer initiates contact with the IRS.

If frozen-refund cases are never referred to or rejected by Examination, they may be left in permanent freeze status. In the TAS-CI QRP Study, TAS identified numerous cases that remained in Z freeze status for over three years. Moreover, CI was unable to tell us how many cases sit in the temporary P freeze status, and for how long, before CI personnel could determine whether the refunds should be released or placed in permanent Z freeze status. It is clear that CI is freezing more cases than it can timely work.[49]

Other IRS Functions Have Inadequate Resources to Promptly Address the "Downstream" Consequences of CI Refund Freezes

As discussed above, the 180-day no-contact rule and the subsequent CI workload delays create work not only for TAS but also for IRS employees who answer the toll-free lines and handle IRS correspondence. Moreover, Examination appears to have difficulty

47 IRS employees are also instructed to make referrals to CI when they identify potentially fraudulent taxpayer behavior in the course of their regular official duties. Numerous Internal Revenue Manual sections describe how referrals should be made to CI, including IRM § 5.1.11.4.7, which describes how Collection personnel make referrals to CI; IRM § 8.2.1.2.2, which describes how Appeals personnel make referrals to CI; and IRM § 4.1.4.16, which describes Examination personnel's referral obligations to CI.

48 If a TAS Operations Assistance Request or a refund inquiry is submitted on a case scheduled to go to Examination, the case is handled as a manual QRP referral.

49 At one FDC, volumes of refund freeze cases were so vast that the FDC asked TAS to detail its employees to work through CI's caseload. While this practice was the product of well-meaning IRS employees, the National Taxpayer Advocate stopped this practice immediately when she learned about it due to concerns about the ethical and legal implications of TAS employees' working on behalf of CI.

handling the volume of cases that CI refers.[50] Because Examination must set aside potentially more productive cases to work some of CI's low-dollar QRP referrals and because the TAS-CI study demonstrates that a significant number and percentage of taxpayer refund claims deemed by CI to be fraudulent are legitimate, we recommend that CI recalibrate both the quality and number of refund freezes to match the resources available to work them.

Through the TAS-CI case study and a survey of Local Taxpayer Advocates co-located with FDCs, TAS identified at least two significant problems in the Examination referral process.

a. CI Referrals to Examination Often Do Not Appear on IRS Data Systems for Months

When Local Taxpayer Advocates (LTAs) advocate on behalf of taxpayers with frozen refunds, they often are unable to find out which Examination office has the responsibility to conduct the examination. This information, which should be available on the AIMS database, is critical because the LTAs cannot forward any required substantiating documentation if they do not know with whom in Examination they should communicate.[51] It is not unusual for CI to inform TAS that a particular case is in Examination and for Examination to inform TAS that it does not have the case. Months later, the case will appear on AIMS in Examination's control.

CI has suggested that TAS be responsible for transferring the case to the appropriate Examination office rather than waiting until Examination establishes the case on the AIMS database.[52] However, this suggestion fails to recognize that the Examination function controls where its examinations are performed, and AIMS is TAS's only means of knowing to which Examination office the case is assigned. At a minimum, CI should better coordinate its Examination referrals so that other functions within the IRS, including TAS, can identify which Examination office has responsibility for the case.

[50] In FY 2004, CI referred 25,096 cases to the IRS Examination function in the Small Business/Self-Employment Division (SB/SE). In FY 2005, CI case referrals increased by 13,470 cases to 38,566. In FY 2004, SB/SE accepted 23,687 CI cases for assignment, but closed only 17,890 with examined disposal codes. With respect to the Wage & Investment Division (W&I), 20,465 CI referrals were accepted for audit but only 16,140 were audited and closed with audit indicators. These data were provided in responses to TAS information requests by the Small Business/Self Employed Division (July 29, 2005) and the Wage & Investment Division (July 22, 2005).

[51] This problem also impacts taxpayers and their representatives when they try to determine where in the IRS their refund claim cases reside.

[52] In its response to a TAS information request provided on Aug. 26, 2005, and supplemented on Sept. 14, 2005, the Criminal Investigation Division suggests:

> A partial solution to this problem would be for TAS to transfer the TAS case (OAR) [Operations Assistance Request] from CI to the appropriate Examination function once the case has been referred and not wait until Examination establishes the AIMS control. This way, there is no doubt which organization is ultimately responsible for the completion of the case. If this occurs, everyone must understand that the controlling FDC still has a say in the final outcome. We realize that this issue is a concern for the affected functions and the MOU [Memorandum of Understanding] being drafted will specifically address these issues.

b. Examination Does Not Have Authority to Release the Refunds in QRP Cases

The IRS Examination function is in the best position to validate taxpayers' assertions with respect to claimed refunds because its examiners are trained to ensure that proper support and documentation is present for claimed refunds. Under current procedures, however, if a QRP examination results in a determination in favor of a taxpayer, the case must be sent back to CI, which may or may not release the refund based on Examination's recommendation.[53] Moreover, all documents and notes from telephonic conversations that Examination receives from the taxpayers must be sent to CI for review.[54]

These back-and-forth exchanges between CI and Examination and the continued control by CI over QRP Examination referrals duplicate work and lead to long delays for taxpayers. Examination should be fully informed of CI's concerns with respect to the refund claim and should be trusted to bring the cases it works to resolution. In our view, CI cases referred to Examination should be fully released to Examination. The Examination function can refer any case back to CI if Examination uncovers additional evidence of fraud.

CONCLUSION

The National Taxpayer Advocate believes that it is generally necessary to freeze questionable refunds before the refunds are issued. However, six core principles must guide this effort:

- Maximum effort needs to be devoted to reducing the high number and percentage of non-fraudulent refund claims that the IRS is now freezing.
- All taxpayers whose refunds are frozen should be notified of the freeze, given an opportunity to present substantiation in support of their claims, and advised of the availability of TAS and Low Income Taxpayer Clinics (LITCs) to assist them with their cases.
- Priority must be given to investigating cases quickly and achieving a reasonable degree of certainty about the existence of fraud prior to imposing a permanent freeze on the account.
- Cases referred to Examination should be referred for all issues and should be resolved in Examination without CI's continued control of the case.
- Innocent taxpayers should be systemically identified so that they do not have to go through the refund freeze process year after year.
- All refund claims require timely closure and a full and fair disposition.

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[53] Memorandum of Understanding, dated May 10, 2004, by and between Director of Office of Refund Crimes, Criminal Investigation and Director of Reporting Compliance, Wage & Investment, For the Referral of Criminal Investigation Cases from the Office of Refund Crimes to Wage & Investment Examination, at 9.

[54] *Id.*

IRS COMMENTS

In her discussion of Criminal Investigation refund freezes, the National Taxpayer Advocate correctly underscores the importance of the IRS Criminal Investigation (CI) organization as a key component of our nation's tax administration system. She also acknowledges that CI keeps millions of dollars from the hands of criminals each year. Unfortunately, the conclusions she reaches about the effect of the Questionable Refund Program (QRP) on eligible taxpayers are drawn from a significantly biased sample and therefore do not accurately represent the effects of the program.

The IRS is constantly working to strengthen our approaches in identifying and preventing fraud– a number of recent changes are discussed later in this response. While we recognize there are opportunities for improvement, we believe the NTA has significantly overstated the problem.

CI performs an invaluable service to the American taxpayer. Since 1977 the IRS has stopped over $5.7 billion in fraudulent refund claims. Since 1999, IRS effectiveness in stopping fraudulent claims improved dramatically through enhanced technological systems and an increased dedication of resources. From 1999 until today the IRS has stopped over $3.1 billion in fraudulent refunds exclusive of two claims totaling $1.8 billion stopped in processing year 2004. Based on our experience – identified fraud has jumped by 322 percent over the past six years – we expect our workload to continue to grow substantially through the rest of the decade.

Part of the CI mission is to detect and stop schemes designed to steal money by people who file false and fraudulent returns. These claims, which defraud every law abiding American taxpayer, attempt to steal hundreds of millions of dollars each year and are proliferated through a broad variety of schemes, including false claims of the Earned Income Tax Credit and prisoner refund schemes. By temporarily delaying less than one half of one percent of refund requests, CI has stopped literally billions of dollars of false refunds to criminals of the legitimate tax dollars paid by honest taxpayers. This excludes the deterrent effect of preventing other refund fraud schemes when criminals learn that this crime does not pay.[55]

We appreciate that the National Taxpayer Advocate acknowledges that the IRS cannot retreat from its critical efforts to stem fraud. Congress also holds the IRS accountable to stop theft from taxpayers and, just in 2005 has held hearings related to important areas that can be subject of refund fraud including the fuel tax credit, prisoner refund schemes and unscrupulous return preparers.

The IRS is constantly working to improve our fraud detection systems. We are keenly aware of the impact our fraud detection activities can have on legitimate taxpayers whose

55 Over the past two years CI has recommended prosecution on 442 individuals who have engaged in refund fraud. For the same time period, 286 individuals were sentenced by federal district courts for this conduct and received an average of 20 months incarceration.

refunds may be temporarily suspended by our systems. That is why we continually strive to eliminate burden on compliant taxpayers through strategic approaches involving systemic and procedural improvements designed to surgically cull out fraudulent returns with minimal impact to legitimate refund returns.

Enhanced data mining systems have allowed Criminal Investigation to increase the detection rate of fraudulent returns and pass over legitimate returns with greater accuracy. In addition, CI evaluates data mining methodologies annually and modifies them based on known identified fraudulent returns. As a result of these enhancements, the accuracy of our identification process has increased. In 2004, the total number of potentially fraudulent returns identified by CI systems numbered approximately 500,000, which represent less than one half of one percent of the over 106 million refund returns filed during the 2004 processing year. Of all potentially fraudulent returns, CI verified that over 118,000 of those were in fact fraudulent which represented $2.2 billion in false claims (including 2 claims for $1.8 billion). In processing year 2005, so far, CI systems have identified approximately the same number of potentially fraudulent claims (500,000) but a higher percentage of those have verified as fraudulent.

The National Taxpayer Advocate's report contains several misleading analytical conclusions. Of particular concern to the IRS is the inaccurate extrapolation of TAS cases to the total universe of CI refund freezes and the erroneous characterization of CI statistics.

First, TAS's conclusion regarding the pool of innocent taxpayers negatively affected by CI account freezes was based on an extrapolation from a limited sample of TAS cases. Innocent taxpayers are much more likely to contact TAS than those who have filed false or fraudulent returns. To extrapolate their conclusions from TAS cases to the whole universe of stopped refunds inflates the universe of innocent taxpayers affected by CI fraud detection programs. TAS acknowledges its extrapolated conclusion is unreliable.[56]

Second, the TAS report relies on inaccurate and misleading data. The TAS report erroneously included returns on which CI had not yet made a final fraud determination in the pool of cases on which they based their statistical conclusions. Thus, they are inflating the number of frozen refund cases that are ultimately resolved in the taxpayer's favor through TAS intervention. Only those returns conclusively determined to be false are placed in CI's Scheme Tracking and Referral System (STARS) and reported in our revenue protection statistics.

The IRS is taking a number of steps to improve our Refund Crimes Program. We concur with TAS that additional resources and improved technological efficiencies would help address the growth in fraud. We also agree that we should ensure taxpayer accounts involving withheld refunds are reviewed and resolved expeditiously, so legitimate

[56] TAS report to Congress dated 12/31/05, MOST SERIOUS PROBLEM: Criminal Investigation Refund Freezes; Footnote 2. "We emphasize that the TAS sample cannot be reliably projected to the full universe of CI cases to reach a firm conclusion on this point."

refunds are released in a timely manner. Criminal Investigation is currently taking the following steps to improve the Refund Crimes Program by enhancing fraud detection while minimizing negative impact on legitimate taxpayers:

- The new Web-based Electronic Fraud Detection System (EFDS) is scheduled for implementation in processing year 2006. One of the major features in this new system will make the Fraud Detection Centers (FDC) more efficient at stopping refunds and provide better management oversight of those refunds that have been stopped.
- Comparison of Earned Income Tax Credit (EITC) returns to the Health and Human Services National Directory of New Hires (NDNH) database is scheduled during processing year 2006. The integration of the HHS system with Web EFDS will enhance the validation process by reducing the burden on employers to verify W2 information/employment and will reduce the impact on legitimate taxpayers by allowing CI to verify income and release legitimate refunds more quickly.
- Recently, CI forwarded letters to employers requesting a more efficient manner of wage verification through fax only contact or electronic media payroll information. This will supplement the NDNH process since not all taxpayers flagged by our process claim EITC or have NDNH data.
- Criminal Investigation will continue to review workload and reallocate employee verification work among FDCs to resolve staffing imbalances.
- In March 2005, CI began issuing Taxpayer Refund Inquiry Letters advising taxpayers that their employer has indicated the wages/withholding were incorrect or that they were not employed. Taxpayers are advised to send any further information to resolve tax matters. CI acknowledges that communications with taxpayers on potentially fraudulent returns is an issue. These communications are limited due to the sensitivity of the potential criminal investigation.
- In June 2005, CI entered into a Service Level Agreement (SLA) with TAS to formalize our mutual concerns and commitment to seek satisfactory remedies.
- Criminal Investigation is partnering with the Federal Trade Commission (FTC) in an attempt to alleviate the impact CI has on victims of identity theft.

The steps outlined above will reduce fraud against our tax system and thereby result in a reduction in TAS case volume. The IRS continuously explores ways to decrease the impact on taxpayers who justly deserve their claimed refunds, while balancing the responsibility of preventing the theft of hundreds of millions of tax dollars each year. We look forward to working with the National Taxpayer Advocate to address all current and future concerns regarding the Questionable Refund Program.

TAXPAYER ADVOCATE SERVICE COMMENTS

We appreciate the openness the CI leadership has shown in discussing its Questionable Refund Program (QRP) with us and in working with us to address the ballooning inventory of CI cases in TAS. We acknowledge the efforts that CI is making to address problems in the QRP. However, the QRP program, as currently administered, raises serious questions about the adequacy of protection for taxpayer rights to a greater degree than any program previously evaluated by the National Taxpayer Advocate.

Based on data from FY 2004, CI may be freezing more than 1.6 million refund claims over a five-year period on a suspicion of taxpayer fraud – without notifying the taxpayers involved of its suspicion of criminality or giving the taxpayers an opportunity to provide documentation to support their refund claims. In hundreds of thousands of these cases, CI claims to have made a "conclusive" determination of taxpayer fraud – and in its Comments above even brands the individuals who filed the claims as "criminals." Yet even in cases where CI has made "conclusive" determinations of fraud and characterized the taxpayers as "criminals," it has not provided the affected taxpayers with any notice or opportunity to present documentation to rebut CI's suspicion before a final "determination" is made.[57]

At a minimum, this procedure constitutes an extraordinary violation of fundamental taxpayer rights and fairness. In our view, it may also constitute a violation of due process of law.

Our concern is heightened by the QRP's limitations in identifying appropriate refund claims for freezes and in making accurate determinations about whether fraud has occurred. As detailed in our initial write-up above and in a research study presented in Volume II of this Report, TAS conducted a survey of a statistically representative sample of cases that were closed by TAS during FY 2004 and the first six months of FY 2005. Among all decided cases in our study where CI had frozen a taxpayer's refund, 66 percent ultimately received a full refund (or more) and an additional 14 percent received a partial refund. Among the decided cases in our study where CI had made a "conclusive" determination of taxpayer fraud, taxpayers ultimately received a full refund in 46 percent of the cases.

TAS estimates that the number of taxpayer refund claims frozen over a five-year period may exceed 1.6 million, although CI does not maintain data on the overall number of refund claims it freezes.

There are at least three distinct categories of refund freezes that affect taxpayers:

- The first category includes refund freezes imposed after CI has *reviewed* a return and made a "determination" of fraud.

[57] At most, CI advises taxpayers that their employers' wage reports do not agree with the information provided by the taxpayers. These letters are not sent to taxpayers on a consistent basis. Moreover, they do not advise taxpayers that failure to present evidence will result in a "determination" of criminal fraud.

- The second category includes refund freezes imposed on all returns where CI has *previously* made a "determination" of fraud and until the taxpayer has filed a certain number of "legitimate" returns, as determined by CI ("prior-year fraud").
- The third category includes *temporary* refund freezes imposed while CI investigates whether to classify a refund claim as fraudulent.

CI tracks the number of refund freezes it imposes after making a determination of fraud. Remarkably, however, CI does not track the number of freezes it automatically imposes due to prior-year fraud determinations. CI also does not track the number of temporary refund freezes it imposes. Therefore, CI does not know how many refund freezes it imposes each year in the aggregate.

For FY 2004, CI reports that more than 118,000 returns were fraudulent. Among the sample of TAS cases we reviewed for FY 2004 and the first half of FY 2005, we believe that the percentage of the total number of cases in which CI made a determination of fraud was 36 percent. If the percentage of cases in TAS could be accurately projected to the full universe of CI cases, one could extrapolate that the number of cases frozen for other reasons, primarily automatic freezes due to a finding of prior-year fraud, is about 210,000, which in turn suggests a total of 328,000 freezes in FY 2004.[58] This estimate is generally consistent with statements made by CI officials that they believe the number of freezes imposed due to prior-year fraud determinations probably exceeds the number of freezes imposed due to determinations of current-year fraud. Although the TAS sample included 37 cases in temporary-freeze status (about eight percent of TAS's frozen-refund cases), extrapolating this number almost certainly understates the overall number of temporary freezes CI imposes because most temporary freezes are released prior to the time a taxpayer would seek assistance from TAS.

We acknowledge that TAS's caseload is not necessarily representative of the total universe of QRP refund-freeze cases. However, in the absence of any CI data on the total number of refund freezes and in light of CI's statements to TAS that the number of freezes imposed due to prior-year fraud determinations probably exceeds the number of freezes imposed due to determinations of current-year fraud, we believe our estimate of 328,000 freezes in FY 2004 provides the most useful ballpark number obtainable. We make no projection about the number of additional temporary freezes.

If our ballpark estimate of freezes in FY 2004 were extended over a five-year period, it suggests that more than 1.6 million refund claims are frozen. In its Comments, CI states that it expects its QRP workload will "continue to grow substantially through the

[58] The TAS sample included 473 frozen-refund cases, and as best we could determine, 171 of those cases, or 36 percent, reflected "final determinations" of fraud. In FY 2004, CI states that it determined fraud in 118,000 cases. Thus, the TAS sample suggests that the total number of frozen-refund cases was about 328,000 (i.e., 118,000 divided by 36 percent), which includes about 210,000 cases in which CI had not made determinations of fraud. We reiterate that the TAS sample is not necessarily representative of non-TAS cases, so we cannot make projections to the broader universe of CI cases with a high degree of confidence. But in the absence of any CI data on the total number of refund claims it freezes, we believe this is the best ballpark estimate available.

rest of the decade," and that in FY 2005, it has made administrative determinations of fraud in a higher percentage of cases than in FY 2004. More current-year fraud determinations mean that more refund claims will be frozen in future years due to CI's policy of freezing refund claims when it has previously found fraud. The increasing number of refund freezes thus compounds each year and is projected to continue to increase.

In the sample of TAS cases reviewed, a significant majority of taxpayers whose refund claims were frozen were ultimately found not to have committed fraud – and the financial burden of the freezes on these taxpayers was significant.

Among the decided cases in our sample of QRP cases, CI ultimately agreed to release the full amount of the refunds claimed in 66 percent of the cases. It awarded partial refunds in 14 percent of the cases. Thus, taxpayers received full or partial refunds in fully 80 percent of the decided cases in our sample.

The median Adjusted Gross Income (AGI) of taxpayers whose refunds were frozen but ultimately released was $13,330, and the median refund was $3,519. *Thus, the refund constituted, on average, more than 26 percent of the claimant's AGI for the year, and these taxpayers were required to wait, on average, more than 8 1/2 months to receive their refunds.* The financial impact on these taxpayers was substantial.

At this point, we do not know whether the results of cases that come to TAS are representative of the full universe of QRP cases. CI believes that TAS cases are not representative, stating, "Innocent taxpayers are much more likely to contact TAS than those who have filed false or fraudulent returns."

The IRS has long suspected that taxpayers who choose to pursue refund claims may be more likely to deserve refunds than taxpayers who do not pursue their claims. While that view has intuitive appeal to individuals who know how to navigate the bureaucracy, many deserving taxpayers do not pursue legitimate refund claims. Many low income taxpayers do not speak English, do not keep complete records, and have no idea how to approach an agency like the IRS. Lacking knowledge of the tax laws, they may even mistakenly assume the IRS has processed their returns properly. Alternatively, taxpayers may be afraid that if they stand up for their rights, the IRS will retaliate, however groundless such a fear may be.

Last year, TAS conducted a study of EITC audit reconsideration cases that, in part, was designed to determine whether taxpayers who respond to IRS notices are more likely to be entitled to receive refunds than taxpayers who ignore IRS notices. Significantly, the study found that the two groups were equally likely to be entitled to refunds.[59]

We do not claim that the results of TAS's cases are representative of the full universe of

[59] National Taxpayer Advocate 2004 Annual Report to Congress vol. II, at 9. Among the cases analyzed in TAS's EITC audit reconsideration study, half the cases were generated by taxpayers who approached the IRS directly and half the cases were generated by taxpayers who approached TAS for assistance in dealing with the IRS. Although taxpayers who worked through TAS fared slightly better, the relief rate was substantially the same for both groups. This result further suggests CI's assumption that innocent taxpayers are more likely to come to TAS is not necessarily accurate.

QRP cases, but neither do we concede that the results are not representative. Unless and until a more thorough study is conducted, the truth is that no one knows. If the results of TAS cases turn out to be representative of the full universe of QRP cases – which is quite possible – then it would appear that out of roughly 1.6 million refunds frozen over a five-year period based on FY 2004 data, taxpayers in more than one million of those cases are entitled to the full amount of the refunds they claimed.[60]

Existing QRP procedures clearly violate taxpayer rights and may violate due process rights as well.

Transparency is a bedrock requirement for a fair tax system. Taxpayers should understand how their tax liabilities are computed, and taxpayers should be advised of any adverse actions the IRS takes or is planning to take as well as the basis for those actions. Where the IRS proposes to take adverse action against taxpayers, due process requires that taxpayers be informed of their rights to challenge that action. Moreover, the tax collector, in particular, owes taxpayers a duty of basic courtesy and fair dealing. It is not courteous and it is not fair dealing for the government to freeze hundreds of thousands of refund claims every year without advising the affected taxpayers of the contemplated action and giving the taxpayers an opportunity to present evidence to support their positions.

The National Taxpayer Advocate further believes that the existing QRP procedures may violate due process protections. It is a central tenet of American law that the government must notify an accused person of the offense it suspects he committed and must give the accused person an opportunity to present exculpatory evidence to show his innocence. In defending its policy of making fraud determinations before notifying taxpayers and before giving them an opportunity to present documentation, CI likely would point out (1) that the IRS ordinarily is not required to respond to a refund claim[61] and (2) that the government does not criminally prosecute the overwhelming majority of the taxpayers whose refunds it freezes, and in the absence of a criminal prosecution, these taxpayers do not acquire due process rights.[62]

[60] CI officials have shown us numerous cases that, on their face, appear to be flagrant examples of fraud. For example, there are cases where taxpayers report Form W-2 wages to obtain EITC refunds but where the employer's name and identifying number on the W-2 do not exist. We don't doubt that there are thousands of these egregious cases every year. But our own experience with CI's frozen-refund cases illustrates that there are also many cases where taxpayers are fully entitled to receive their refunds, and if taxpayers are not afforded an opportunity to submit documentation, it is difficult to know when an apparently egregious violation may be easily and persuasively explained.

[61] IRC § 6532(a) provides that a taxpayer may file a refund suit for up to two years from the date the IRS issues a notice of disallowance in response to a refund claim. Implicit in this statute is that the IRS is not obligated to issue a notice of disallowance and that, in such cases, the taxpayer retains the right to file a refund suit in perpetuity.

[62] In its response, CI speaks of a "deterrent effect" of the QRP "when criminals learn that this crime does not pay." By CI's own statistics, however, it determined fraud in more than 118,000 cases in FY 2004, yet over the past two years, it recommended only 442 individuals for prosecution and persuaded a court to sentence only 286 individuals. If we assume half the recommended prosecutions and convictions over the two-year period occurred in FY 2004, these statistics indicate that only about 1.9 out of every 1,000 individuals who file fraudulent returns are recommended for prosecution and only about 1.2 out of every 1,000 such individuals are convicted and sentenced. If CI routinely sent letters to taxpayers suspected of committing fraud and engaged them earlier in the process, it appears to us that the existence of its Refund Crimes Program would become more widely known and the deterrent effect would increase substantially.

It is clear that the IRS is not obligated to respond to routine refund requests (although we believe it is preferable that the IRS respond). However, it is longstanding IRS policy that where a taxpayer asserts a refund claim on a tax return, the IRS should proceed under deficiency procedures. Where deficiency procedures are not possible or practicable because the statutory period for assessment is about to or has already expired, the IRS advises the taxpayer of his or her right to file a suit in federal district court or the U.S. Court of Federal Claims. Where CI controls a case, however, its procedures do not require that taxpayers be advised of any such protections until considerable time has expired, if ever, and CI does not have the authority to issue notices of deficiency.

In QRP cases, moreover, the IRS is investigating whether individuals have committed *fraud*. There is a significant distinction between a mere overclaim and fraud. A finding of fraud represents a determination that an individual has deliberately sought to steal money from the government. The government, in these cases, may seek to assess criminal or significant civil penalties. Even where it does not take these steps, the three-year period of limitations on assessing additional tax does not apply to returns determined to be fraudulent, so the authority of the IRS to assess additional tax never expires. Moreover, the IRS automatically freezes future refund claims filed by the taxpayer until the taxpayer has filed a certain number of "legitimate" returns – again, as determined by CI without consulting with the taxpayer.

The National Taxpayer Advocate believes violations of due process of law may exist where (1) IRS's *criminal* investigation function (2) makes more than 100,000 "final determinations" of fraud each year which means that (3) the standard three-year period of limitation on assessing additional tax never expires, (4) CI characterizes these tax filers as *criminals*, and (5) CI *automatically* freezes future refund claims filed by these individuals[63] – all without notifying the taxpayers of CI's suspicion of fraud or giving the taxpayers an opportunity to rebut the suspicion before a determination is made.

The "revenue protection" claims made by CI are inaccurate precisely because CI makes final determinations without providing taxpayers with a meaningful opportunity to rebut its allegations of fraud.

On its website, in congressional testimony, and in its response above, CI makes assertions regarding the amount of "revenue protected" by the QRP as if its data are infallible – almost as if the data reflect the results of criminal prosecutions.

In its response, for example, it states that "[s]ince 1977, the IRS has stopped over $5.7 billion in fraudulent refund claims," "[o]f all potentially fraudulent returns [identified in FY 2004], CI verified that over 118,000 of those were in fact fraudulent," and "[o]nly

[63] CI's policy of automatically freezing future refund claims is particularly questionable. Not only does CI make a determination of fraud that may be erroneous in Year 1 without advising the taxpayer, but it then automatically freezes future refunds based on the Year 1 determination until the taxpayer has filed a certain number of "legitimate" returns (again, as determined by CI). We are not aware of any studies showing that the look-back period CI uses is optimal for detecting future fraud, and in fact, four out of every five taxpayers in our survey of TAS cases whose refunds were frozen due to CI's "finding" of prior-year fraud ultimately received a full refund.

those returns conclusively determined to be false are…reported in our revenue protection statistics."

In fact, CI's revenue protection statistics are inaccurate, and we find it remarkable that a criminal investigation function of the United States government is making "final," "conclusive[]" determinations of fraud without notifying the individuals it suspects of committing the fraud. To be clear, individuals accused of committing an offense are not generally required to be notified solely as a courtesy. They are notified because they often possess information that would lead a decision maker to reach a different conclusion about guilt or innocence. Because CI does not give individuals an opportunity to present their cases before reaching its conclusions, it is hardly surprising that its revenue protection statistics are inflated.

Among cases that came to TAS, our study examined a subset of returns in which we believe CI reached a conclusive determination of current-year fraud and thus included the taxpayers and the associated amount of frozen refunds in its "revenue protection" statistics. After we assisted these taxpayers in presenting their cases, CI ultimately agreed that 46 percent of the taxpayers were entitled to full refunds.

Moreover, as noted above, there is a significant distinction between an overclaim that results from error and an overclaim that results from fraud. Even leaving aside the percentage of cases included in CI's revenue protection estimates in which taxpayers are entitled to full refunds, we suspect that a significant percentage of additional claims reflect mere error, or even negligence, rather than fraud. To label all such cases as fraud is misleading, subjects the affected taxpayers to automatic refund freezes in the future, and constitutes a disservice to the integrity of this country's taxpayers.

RECOMMENDATIONS

1. **Effective immediately, the IRS should notify all taxpayers within two weeks whenever it places a freeze on a refund claim.** If the freeze is temporary and the IRS is seeking to validate the taxpayer's claim through third parties, the notice to the taxpayer should so state. If the IRS is contemplating a permanent freeze, CI should give the taxpayer an opportunity to present documentation *before* it makes a decision about whether to classify the claim as fraudulent and should advise the taxpayer of the availability of TAS and Low Income Taxpayer Clinics (LITCs) to assist with the case.

   CI justifies its failure to notify taxpayers as necessary in certain cases to protect ongoing criminal investigations. We agree with the point. However, that interest should not override the protection of fundamental taxpayer rights. CI currently does not even know how many refund freezes it imposes, and because it does not generally give taxpayers the right to contest its findings of criminal fraud, there is no objective way to determine by how much its revenue protection statistics are overstated. Moreover, as we discussed in our initial write-up above, the amount of revenue protection generated by the QRP is fairly modest. We therefore believe that the IRS needs to get a better handle on the breadth and accuracy of the QRP – including keeping data on the number of refunds frozen under each type of freeze, the duration of the freezes, and the disposition of claims – and then develop carefully limited criteria under which it may freeze refund claims for a period of time without notifying taxpayers. Until the IRS develops appropriate criteria to determine which freezes to keep secret and for what period of time, it should err on the side of full notification; the presumption should be that taxpayers are to be notified unless there is a compelling justification for keeping the investigation secret.

2. **Once CI "determines" that fraud exists, it should immediately refer the case to the Examination function or it should immediately notify the taxpayer of his or her right to file a refund suit in a United States district court or the United States Court of Federal Claims.** This notification is vital for due process, since CI by its own admission rarely, if ever, refers these claims for prosecution. Thus, taxpayers' claims now may remain in limbo for years. Because the period for assessing tax never closes where a return is fraudulent, the taxpayer could be subject to assessment of tax on other issues indefinitely for that tax year. And because the taxpayer's right to file a refund suit does not close until two years after the IRS' issuance of a notice of disallowance of the claim, the government is subject to suit in perpetuity when a notice of disallowance is not issued. It is unacceptable for taxpayers and the government alike to be so exposed in hundreds of thousands of cases each year.

3. **The IRS should give serious consideration to moving the initial screening outside the Criminal Investigation function.** The placement of initial screening within the CI function is not a good fit. Some of the issues raised in this write-up illustrate why. In our view, the Examination function should conduct initial screenings. The key to detection of overclaims – whether deliberate or inadvertent – is proper case selection. The IRS Examination function has the most experience and expertise in case selection. Where Examination suspects criminal wrongdoing, it should refer cases to CI. Where it does not suspect criminal wrongdoing, there is no benefit to involving CI. The Examination function is fully capable of protecting revenue in non-criminal cases and is more likely to achieve accurate case resolutions because it provides taxpayers with notice of proposed changes to tax and afford taxpayers an opportunity to provide documentation. In egregious cases that do not rise to the level of criminal fraud, Examination can propose the civil fraud penalty as well.

4. **The IRS should devote additional resources to improving the accuracy of its screening methods.** Screening over 100 million refund returns each year is a challenging task, and the IRS will never be able to design an algorithm that is perfect. But it must devote sufficient resources to refining its screening criteria each year to achieve an appropriate balance between revenue protection and taxpayer rights.

Except in unusual circumstances, the close calls should be resolved in favor of giving America's taxpayers the benefit of the doubt. Moreover, we believe that these screening resources should be placed in the Examination function.

5. **The IRS should review CI's policy of freezing refunds for a certain number of years after it "determines" fraud on a taxpayer's return.** The IRS should consider whether the revenue effects of reducing the number of years for which it imposes future refund freezes, or even eliminating this basis for imposing future refund freezes, are significant enough to justify the continuing burden on taxpayer rights (particularly since nearly 80 percent of the taxpayers in the TAS sample whose refunds were frozen due to prior-year fraud ultimately received the full amount of the refunds they claimed) as well as the additional costs the agency incurs in working cases that arise from this policy

6. **CI should facilitate a study of a random sample of frozen-refund cases in which the affected taxpayers have not contacted TAS**. The sample should include cases in which refunds have been frozen due to a determination of current-year fraud, cases in which refunds have been frozen due to a determination of fraud in a prior year, and cases placed in temporary freeze status. The study should examine the duration of the refund freezes and the various steps in the process as well as the outcomes. While the taxpayers selected for this study should be ones who have not *initiated* contact with TAS, many of these taxpayers will not understand IRS procedures and might be intimidated if contacted by CI or an audit agency like the Treasury Inspector General for Tax Administration. Therefore, we recommend that the study be conducted in conjunction with TAS and that the cases be referred to TAS so that the taxpayers receive assistance in understanding the process and substantiating their claims.

7. **When releasing reports of revenue protected by the QRP, the IRS should be more complete in describing the achievements and limitations of the QRP.** The amount of revenue protected by the QRP is a significant factor for the IRS in making budgeting decisions and for congressional oversight committees in evaluating the program. To provide revenue protection statistics as if they are clearly correct and talk about having "verified" fraud without pointing out that taxpayers have had no opportunity to rebut the assertion of fraud provides a distorted portrait of the effectiveness of the program – both from the standpoint of the amount of revenue actually "protected" and from the standpoint of whether taxpayer rights have been respected to the degree congressional oversight committees might expect from the nation's tax administrator.

PROBLEM

TOPIC #3 MOST SERIOUS PROBLEM: THE CASH ECONOMY

RESPONSIBLE OFFICIALS

Mark E. Matthews, Deputy Commissioner, Services and Enforcement

Kevin M. Brown, Commissioner, Small Business/Self Employed Operating Division

Richard J. Morgante, Commissioner, Wage & Investment Operating Division

DEFINITION OF PROBLEM

Underreporting of tax is the single largest component of the "tax gap," accounting for 80 percent of the tax gap or $251 billion to $291 billion per year.[1] Although the IRS has no direct estimate of the portion of the tax gap attributable to the so called "cash economy," IRS researchers estimate that taxpayers primarily underreport income that is not subject to withholding or information reporting, *i.e.*, income from the cash economy.[2] According to the IRS, taxpayers report:[3]

- 99 percent of the income subject to withholding (*e.g.*, wages),
- 96 percent of the income subject to third-party information reporting (*e.g.*, interest),[4] and
- 68 percent of the income not subject to withholding or information reporting (*e.g.*, inventory sales proceeds).

This percentage drops to 20 percent for income earned by certain sole proprietors (called "informal suppliers") who operate "off the books" on a cash basis in areas such as street vending, door-to-door sales or moonlighting in a trade or profession.[5] These statistics suggest that unreported income from the cash economy may be the single largest component of the tax gap.

Except for costly field examinations, the IRS's traditional enforcement tools are unlikely to be effective in detecting unreported income from the cash economy because they rely on information reporting. The IRS has a number of initiatives that could be effective if coordinated and pursued more aggressively. However, no single function coordinates

[1] IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005). The "tax gap" or "gross tax gap" is the gap between the amount of tax imposed by law and the amount voluntarily and timely paid by taxpayers for a given tax year. The "net tax gap" is the portion of the gross tax gap that will remain uncollected after all IRS and taxpayer actions have been completed for a given tax year.

[2] We use the term "cash economy" to mean payments for transactions that are not reported to the IRS. For a similar definition of cash economy, s*ee Bridging the Tax Gap: Hearing Before the Committee on Finance, United States Senate*, 108th Cong., 21 (July 21, 2004) (statement of Professor Joseph L. Bankman defining the cash economy as "legal business transactions conducted in cash (or checks) that are not subject to withholding or third-party information… your gardener, the family that owns the corner restaurant. Anyone that is getting cash or checks that is not subject to third-party reporting").

[3] IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001* 22-23 (Feb. 24, 2004).

[4] This percentage drops to 93 percent for income that is only subject to some information reporting (*e.g.*, capital gains). *Id.*

[5] IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001* 22-23 (Feb. 24, 2004).

research, outreach, and compliance initiatives aimed at improving reporting compliance among cash economy participants. Nor does the IRS give these initiatives the same level of attention as other initiatives, such as those addressing tax shelters or the Earned Income Tax Credit. The IRS must develop a comprehensive strategy for addressing the cash economy if it is to significantly reduce the tax gap.

ANALYSIS OF THE PROBLEM

Background

The Tax Gap

The tax gap generally represents the gap between the amount of tax that taxpayers are required by law to pay each year and what they actually pay on a timely basis. The IRS's most recent estimates, based upon returns for the 2001 tax year, indicate that the gross tax gap is between $312 billion and $353 billion.[6] After accounting for amounts the IRS receives as late voluntary payments or as a result of collection activity, the net tax gap is between $257 billion and $298 billion per year.[7]

The collective failure by certain taxpayers to pay their taxes imposes greater burdens on others. Given the size of the net tax gap, the average tax return includes a "surtax" of about $2,000 to make up for tax revenue lost to noncompliance.[8] The tax gap may also impose significant costs on businesses in the form of unfair competition by noncompliant competitors who can pass along a portion of their tax "savings" to customers by charging lower prices. Moreover, a continuing and persistent tax gap could create a cycle of noncompliance as it erodes confidence in the government's ability to enforce the law and makes compliant taxpayers feel foolish for reporting all of their income and paying all of their taxes.

The Cash Economy

The IRS has no direct estimate of the portion of the tax gap attributable to the so called "cash economy." However, according to IRS estimates:

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6 IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005). The tax gap estimates do not include taxes due on illegal transactions.

7 *Id.*

8 The IRS receives approximately 133 million individual income tax returns each year. IRS Pub. 1136, *Statistics of Income Bulletin, Spring 2005* (Feb. 2004) (Table 22). The lower range of the net tax gap ($257 billion) divided by the number of individual income tax returns (133 million) is $1,932 per return. The upper range of the net tax gap ($298 billion) divided by the number of individual income tax returns (133 million) is $2,240 per return.

- More than 60 percent of the tax gap is attributable to self-employed individuals.[9]
- Eighty percent of the tax gap is attributable to underreporting of tax.[10]
- About 43 percent of the tax gap, $134 billion to $155 billion, is attributable to underreporting by self-employed individuals.[11]
- Over 80 percent of all individual underreporting is attributable to understated income rather than overstated deductions.[12]

These estimates suggest that self-employed taxpayers who file returns but underreport their income (or self-employment taxes) represent the single largest component of the tax gap, accounting for more than a third of the gap and over $100 billion per year. Further, the IRS's estimates may understate the portions of the tax gap attributable to the cash economy because such noncompliance is inherently difficult to detect.[13] Taxpayers, including the self-employed, primarily underreport income that is not subject to third-party information reporting, *i.e.*, income earned in the cash economy.[14] Practitioners confirm that the IRS is frequently unable to deter or detect underreporting among cash economy participants.[15]

Research suggests that the cash economy is growing. According to one estimate the "underground economy," which includes both the cash economy and illegal activities, increased from four percent of the U.S. Gross National Product in 1970 to nine percent

9 IRS National Headquarters Office of Research (unpublished projections furnished for TY 2001) (indicating that self-employed taxpayers are responsible for about 67 percent of the tax gap). This estimate includes underreporting, non-filing and non-payment of income, self-employment, and employment taxes by self-employed taxpayers. It is consistent with prior estimates. *See* Small Business/Self-Employed, *Strategic Assessment Report FY 2005-2006*, 5 (Feb. 23, 2004) (stating that SB/SE taxpayers are responsible for 56 percent of the tax gap); SB/SE Research, *Small Business/Self-Employed Compliance Risk Assessment*, FY 04-05 Strategic Planning Cycle 28 (Jan. 31, 2003) (stating that Schedule C filers are responsible for 59.2 percent of the tax gap).

10 IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005).

11 IRS estimates indicate that taxpayers who underreport business income on individual returns account for $83 to $99 billion of the tax gap and taxpayers who underreport self-employment taxes accounts for another $51 to $56 billion. IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005).

12 *Id.*

13 *See* IRS, Office of Research, Analysis, and Statistics (RAS), *Preliminary Update of the TY 2001 Individual Income Tax Underreporting Tax Gap Estimates* 8-16 (June 7, 2005); James Alm & Brian Erard, *Estimating the Informal Supplier Tax Gap*, 2005 IRS Research Conference (June 7, 2005) *available at* http://aysps.gsu.edu/people/working/IRS2005ResearchConference-Alm_Erard-Abridged.doc. *See also*, Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* 12 (July 2005).

14 IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001* 22-23 (Feb. 24, 2004).

15 SB/SE Research – Brooklyn/Hartford, Project 01.08.003.04, *TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups* 12 (Dec. 2004). For a comparative analysis of compliance by self-employed taxpayers operating in the cash economy, see Piroska Soos, *Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues*, 24 U.C. Davis L. Rev. 107 (Fall 1990).

in 2000.[16] A recent study suggests that between nine and 29 percent of the workers in Los Angeles County California are paid in cash and do not have federal or state payroll taxes withheld.[17] The cash economy may grow even faster as cash transactions move to the Internet.[18]

Traditional Enforcement Tools Not Effective for Cash Economy

Except for costly field examinations, the IRS's traditional enforcement tools heavily rely on information reporting. The IRS frequently uses its Examination, Automated Underreporter (AUR, also called Document Matching), and Automated Substitute for Return (ASFR) programs to contact taxpayers to resolve unreported income and non-filing issues. The AUR program automatically matches the items reported on a tax return with information reported by third parties on information returns.[19] Similarly, ASFR relies on data from information returns or prior year returns to prepare substitute returns and assessments for individuals who fail to file after the IRS sends them a notice.[20] Correspondence examinations, which are generally limited to a single issue, also rely heavily on information reporting.[21]

In contrast to Correspondence Examiners, the Revenue Agents and Tax Compliance Officers who conduct field and office examinations, respectively, are not limited to a single issue and will change their focus in response to new information.[22] This approach allows Revenu Agents to find unreported income that a limited-scope correspondence examination would not detect. For example, agents are supposed to conduct certain "filing checks" to ensure that taxpayers have filed all of their returns, including information returns.[23] These checks may lead to an expansion of the audit to include

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16 *See* Friedrich Schneider & Dominik Enste, *Economic Issues No. 30 – Hiding in the Shadows: The Growth of the Underground Economy*, IMF, March 2002. For more recent discussion see Jim McTague, *Underground Economy*, Barron's, Jan. 3, 2005.

17 *See* Pascale Joassart-Marcelli and Daniel Flaming, *Workers Without Rights: The Informal Economy in Los Angeles*, Economic Roundtable Briefing Paper, 2002.

18 According to practitioners, Internet sales frequently go unreported. SB/SE Research – Brooklyn/Hartford, Project 01.08.003.04, *TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups* 12 (Dec. 2004) (noting that practitioners believe there is a lot of unreported income from internet sales, such as income generated on the E-Bay website). *See also*, Treasury Inspector General for Tax Administration, Ref. No. 2005-30-010, *The Internal Revenue Service Is Making Progress in Addressing Compliance Among Small Businesses Engaged in Electronic Commerce* (Nov. 2004) (citing a March 2004 estimate that the tax gap among small businesses that are doing business over the Internet may be as high as $1 billion and growing quickly).

19 *See, e.g.*, Department of the Treasury, Internal Revenue Service, *Report to Congress: IRS Tax Compliance Activities* 5 (July 15, 2003).

20 *See* IRM § 5.1.11.6.5 (May 27, 2003).

21 *See, e.g.*, IRM § 4.10.1 (May 14, 1999) (providing that Revenue Agents and Tax Auditors (not Correspondence Examiners) use sophisticated income probes); IRM § 4.19.1.2.3.1(12) (Oct. 1, 2004) (providing that Correspondence Examiners rely on information reporting to detect unreported income).

22 IRM § 4.10.4.1(2) (June 1, 2004).

23 IRM § 4.10.5 (July 31, 2001). We have not analyzed how often such filing checks actually occur.

additional years or other taxpayers, which can uncover unreported income.[24] Revenue Agents can also use more sophisticated methods to detect unreported income. For example, they can observe the taxpayer's business operation.[25]

Ineffective Enforcement Tools May Reduce Voluntary Compliance

Because AUR, ASFR, and correspondence examinations rely so heavily on information reporting, they may actually teach noncompliant taxpayers who operate in the cash economy that they do not have to report income unless it is subject to information reporting.[26] Indeed, a taxpayer with a significant amount of income from the cash economy may be happy to pay the tax liability shown on a return generated by the ASFR Program because the return will only reflect the fraction of his or her income subject to information reporting.[27]

The IRS's over-reliance on information reporting may reinforce the belief held by some cash economy participants that only income subject to information reporting is subject to tax.[28] Such perception may result from the fact that the IRS is unlikely to detect underreported income unless it is subject to information reporting.

Effective Enforcement Tools are Costly and Used Sparingly

Field examinations (and possibly office examinations), which do not rely as heavily on information reporting, are more expensive than processes that do, such as AUR, ASFR and correspondence examinations. Typically, Revenue Agents who conduct field examinations are more highly paid than Tax Compliance Officers who conduct office examinations and Correspondence Examiners who conduct correspondence

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24 *See* IRM § 4.10.5 (May 14, 1999).

25 IRM § 4.10.4 (June 1, 2004); IRM § 4.10.4.3.5 (June 1, 2004). Similarly, when a revenue officer (*i.e.*, an IRS collection employee working in the field) files a substitute for return for a high income nonfiler, he or she is required to observe the taxpayer to determine if sufficient income is reflected on the information reporting documents before filing the substitute for return. *See* IRM § 5.1.11.6.3.1 (May 5, 2003).

26 As early as 1996, IRS researchers observed:

> Although the overall impact of IRP [the information reporting program] has been to improve the reporting of income, as well, it is not clear what impact new types of IRP documents have had in the recent past. Their positive deterrent may be mitigated somewhat by a 'What the IRS doesn't know won't hurt them' type of mentality. That is, taxpayers could improve their reporting of IRP-covered income types, but reason that income not reported to IRS is easy to conceal. The more taxpayers are aware of the limits of IRS knowledge, the more opportunity they have to underreport their income.
> Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 18 (Oct. 1996).

27 However, IRS collection personnel in the field could discover unreported income through a Tax Delinquency Investigation. *See, e.g.*, IRM § 5.1.11.6.3.1 (May 5, 2003) (requiring Revenue Officers to observe high income nonfilers to determine if information reporting understates their income before filing a substitute for return).

28 One IRS focus group found that "[P]ractitioners say cash businesses are wide open for tax cheating. 'Cash doesn't count' is what many of their clients think." SB/SE Research – Brooklyn/Hartford, Project 01.08.003.04, *TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups* 9 (Dec. 2004).

examinations, as well as the IRS employees working ASFR and AUR processes.[29] Field examinations also take much longer than office and correspondence examinations. In FY 2004, on average, field examinations took 318 days, office examinations took 256 days, and correspondence examinations took 205 days.[30] The IRS conducts ASFR and AUR processes, which are highly automated, even more rapidly and at less (initial) cost than correspondence examinations.[31]

Because of the time and cost involved in field examinations, the IRS uses them sparingly. In FY 2004, the IRS closed 1,948,363 AUR cases, 1,585,259 ASFR cases, and 1,007,874 individual income tax return examinations.[32] However, it only examined 195,054 individual returns using either field or office examinations.[33]

IRS Enforcement Priorities

The IRS currently places priority emphasis on combating tax shelters and abusive schemes used by corporations and high income individuals to facilitate underreporting.[34] The publicity resulting from this strategy may be useful to curb the public's perception that low and middle income taxpayers should not bother to report and pay their taxes since high income taxpayers and corporations do not properly report and

29 United States Office of Personnel Management, *Operating Manual, Qualification Standards for General Schedule Positions* (Mar. 22, 1999); AWSS Human Resources Systems Office (HRSO), Workforce Information by Organization (June 11, 2005).

30 SB/SE, AIMS Closed Case Database, IRS Examination Table 37 (Aug. 2005).

31 In FY 2004, 278 full time equivalent employees (FTEs) handled 1,585,259 ASFR cases (5,702 per FTE), 1,639 FTEs handled 1,948,363 AUR cases (1,189 per FTE), and 1,569 FTEs handled 810,486 correspondence examinations (517 per FTE). *Id*; IRS Pub. 55B, Data Book, Table 26 – Taxpayer Contact Information, by Type of Math Error and Selected Program, FY 2004; Senior Tax Analyst, SB/SE Campus Compliance Services, Campus Reporting Compliance, Workload Selection & Delivery, Response to TAS Information Request (Oct. 7, 2005).

32 IRS Pub. 55B, *Data Book*, Table 26 - Taxpayer Contact Information, by Type of Math Error and Selected Program, FY 2004 (ASFR and AUR statistics); IRS Pub. 55B, Data Book, Table 10 – Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, FY 2004. However, 48 percent of the individual income tax returns examined (487,461 returns) claimed the earned income tax credit, leading the Internal Revenue Service Advisory Council (IRSAC) to conclude that EITC has been singled out for disproportionate emphasis as compared to other areas of tax noncompliance. Id; Internal Revenue Service Advisory Council, Public Meeting, Wage & Investment Subgroup 7 (Nov. 17, 2005) *available at* http://www.irs.gov/pub/irs-utl/2005_irsac_public_meeting.pdf.

33 IRS Pub. 55B, Data Book, Table 10 – Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, FY 2004. To its credit, however, the IRS was more likely to examine non-EITC Schedule C returns using a field examination in FY 2004 than in FY 2003. SB/SE, AIMS Closed Case Database, IRS Examination Table 37 (Apr. 2005).

34 *See* IRS Pub. 3744, *Strategic Plan 2005-2009* 19 (June 2004).

pay theirs.[35] In addition, the direct revenue gains from each audit are generally higher for corporations and high-income taxpayers than for low and middle income participants in the cash economy.[36] However, if the IRS is to significantly reduce the tax gap it must have a strategy to address the largest portions of the tax gap, including the cash economy. There is simply no way to make significant progress in reducing the tax gap if the IRS fails to focus on its largest component. If taxpayers operating in the cash economy believe that the IRS is devoting most of its attention to going after tax shelters, they may be emboldened to cheat even more.

The IRS's Current Efforts to Address the Cash Economy

The IRS is pursuing a number of initiatives that could be effective in addressing noncompliance in the cash economy, especially if it improved, coordinated, and pursued them more aggressively. These efforts include:

- *The Unreported Income Discriminant Function (UI-DIF).* UI-DIF is a tool for identifying returns that are most likely to have unreported income.[37] IRS research recently concluded that a high UI-DIF score may be a good predictor of unreported income by Schedule C filers (non-farm sole proprietorships) with gross income in excess of $25,000.[38] However, the UI-DIF needs to be refined. Examinations of returns that included Schedule C but did not claim the Earned Income Tax Credit (EITC), which were selected using other methods, resulted in higher recommended tax deficiencies in FY 2004 than examinations of non-EITC Schedule C returns selected using UI-DIF.[39]

  The IRS began to refine and use the UI-DIF in FY 2004 and FY 2005.[40] It closed 10,266 examinations of non-EITC Schedule C returns selected using UI-DIF in FY 2004.[41] Such examinations represent 24 percent of all non-EITC Schedule C

35 However, this strategy could have the reverse effect by emphasizing to the public how little tax high income taxpayers and corporations actually pay, reducing their incentive to pay their share. Further, one study found that high income taxpayers did not increase compliance in response to audit threats, perhaps because they viewed an audit as a negotiation and they wanted to start negotiating from a low number. *See* Stephen Coleman, *The Minnesota Income Tax Compliance Experiment: State Tax Results*, Minnesota Department of Revenue (Apr. 1996).

36 *See generally*, IRS Pub. 55B, *Data Book*, Table 10 – Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, FY 2004.

37 *See generally*, Treasury Inspector General for Tax Administration, Ref. No. 2003-30-146, *Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program* (July 2003).

38 Denver SB/SE Research, Project 03.08.002.03, *Research Report: Utilize Exam Results to Further Evaluate UI DIF Scores* iii (Mar. 2005) (analyzing returns for tax years 1999-2001). However, the study did not reach statistically valid conclusions, in part, because an unexpectedly low percentage of the examinations included an adequate unreported income probe. *Id.*

39 SB/SE, AIMS Closed Case Database, Extract of FY 2004 Audit Results (Oct. 28, 2005).

40 *See* IRS Pub. 3744, *IRS Strategic Plan 2005-2009* 19 (June 2004); SB/SE Strategy and Program Plan FY 2004 – FY 2005 28 (Sept. 25, 2003).

41 Senior Program Analyst, SB/SE, Exam Planning & Delivery, Exam Return Selection, Response to TAS Information Request (Oct. 21, 2005). The IRS closed 15,873 such examinations in FY 2005. *Id.*

examinations closed in the field in FY 2004.[42] The IRS recently abandoned UIDIF, however, because of its limited utility, delays in selecting cases, and the cost of classifying returns.[43]

- *Examining More Sole Proprietors in the Field.* A field examination is the most effective type of examination for detecting unreported income from the cash economy. Although the likelihood that the IRS would examine a sole proprietor did not change significantly between FY 2003 and FY 2004, the likelihood that a sole proprietor selected for examination would be examined in the field increased. The percentage of all non-EITC Schedule C examinations that were conducted in the field (rather than in an office or by correspondence) increased from 35 percent in FY 2003 to 47.5 percent in FY 2004.[44] We understand that the IRS tentatively plans to examine more non-EITC Schedule C examinations in the field in FY 2006 than in FY 2005.[45]
- *Obtaining State and Local Tax Information.* The IRS receives information from state and local governments. As of February 2004, the IRS had 1,925 agreements and initiatives in place to share information with and receive information from federal, state, and local government agencies.[46] Although the IRS's primary focus is to use state information to identify business non-filers and tax shelter investors, a number of these initiatives may address compliance by cash economy participants, such as the following:[47]
  - **The State Revenue Agent Report Initiative.** The IRS regularly receives examination reports from some states that it can use to identify corresponding federal tax adjustments.[48] For example, the IRS receives individual income tax audit reports from Alabama, Iowa, Michigan, Montana, New York, North Carolina, Virginia, and Wisconsin.[49] On March 11, 2005, the IRS began contacting state and local agencies to seek more state examination reports.[50]
  - **The State Sales Tax Matching Project.** Some states provide the IRS with sales tax records that it can match against income tax records to identify potential

42 SB/SE, AIMS Closed Case Database, Extract of FY 2004 Audit Results (Oct. 28, 2005).

43 IRS Response (Dec. 23, 2005).

44 SB/SE, AIMS Closed Case Database, Examination Table 37 (Apr. 2005).

45 IRS Response (Dec. 23, 2005).

46 IRS Office of Governmental Liaison, Response to TAS Information Request (July 27, 2005).

47 *See* IRS Pub. 3744, *IRS Strategic Plan 2005-2009* 20 (June 2004); *Bridging the Tax Gap: Hearing Before the Committee on Finance, United States Senate*, 108th Cong., 2nd Sess. 50 (July 21, 2004) (statement of Commissioner Everson). *See also* IR-2004-77 (June 7, 2004).

48 IRS Office of Governmental Liaison, Response to TAS Information Request (July 27, 2005).

49 *Id.* The IRS reports that the SB/SE Government Liaison & Disclosure is currently receiving reports from 38 states under this initiative. IRS Response (Dec. 23, 2005).

50 Memorandum from Director, Governmental Liaison & Disclosure, SB/SE for Area Managers, Governmental Liaison & Disclosure, Interim Procedures for Obtaining State Tax Audit Results While Revisions are Made to the Existing Implementing Agreements (Mar. 11, 2005).

unreported income.[51] For example, the IRS receives sales tax audit reports from California, Illinois, Iowa, Massachusetts, Minnesota, Missouri, New York, North Carolina, North Dakota, South Dakota, and Tennessee.[52]

- **Ad Hoc Initiatives**. The IRS has a variety of ad hoc information sharing initiatives with various states and localities. For example, the IRS obtains lists of current business license holders to identify nonfilers.[53]

In FY 2005, the IRS considered 1,092 state information items for examination potential.[54] About 60 percent (652) of these items resulted in an examination.[55] The fact that 60 percent led to an examination suggests the IRS is getting relatively good leads from the states. The fact that the IRS only considered 1,092 items generated by 1,925 agreements and federal-state initiatives suggests that the IRS may receive a significant number of good leads that it is unable to consider.[56]

- *Obtaining Information on Cash Transactions in Excess of $10,000.* Any person who, in the course of a trade or business, receives more than $10,000 in cash in one transaction (or two or more related transactions) is required to inform the IRS by filing Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*.[57] The IRS uses information from Form 8300 to identify returns that may have unreported income.[58] In FY 2005, the IRS reviewed 2,366 Forms 8300 and had 170 open examinations that resulted from Form 8300 reviews.[59]

- *Entering Into Voluntary Compliance Agreements.* The IRS sometimes enters into voluntary compliance agreements, including TIP agreements, to improve reporting

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51 IRS Office of Governmental Liaison, Response to TAS Information Request (July 27, 2005).

52 *Id.*

53 IRS Office of Governmental Liaison, Response to TAS Information Request (July 27, 2005). For example, the New York State Department of Taxation and Finance provides information about liquor license holders, licensed cosmetologists, real estate agents, appraisers, architects, and accountants to the IRS. The Michigan Bureau of Revenue, North Carolina Department of Revenue, Virginia Department of Alcoholic Beverage Control, and Washington Department of Licensing provide similar information to the IRS. *Id.*

54 Director, Examination Planning & Delivery, Response to Information Request (Oct. 12, 2005). Prior to March 2005, the IRS did not track how many items of information it received from states. IRS Office of Governmental Liaison, Response to TAS Information Request (Nov. 2, 2005). Since March 2005, the IRS has received 14,377 state income tax audit reports, but has not evaluated any of them. Senior Program Analyst, SB/SE Campus Compliance Services, Campus Reporting Compliance, Workload Selection & Delivery, Response to TAS Information Request (Nov. 10, 2005).

55 Director, Examination Planning & Delivery, Response to Information Request (Oct. 12, 2005). However, IRS computer systems only reflect 233 closed examination cases resulting from state information referrals in FY 2005. SB/SE, AIMS Closed Case Database, Examination Table 37 (Nov. 9, 2005) (source code 77).

56 We understand that the IRS's Office of Governmental Liaison refers its leads to Exam and that some leads are not actionable.

57 *See* IRC § 6050(I).

58 *See* IRM § 4.26.15.4 (Jan. 1, 2003).

59 Acting BSA Compliance Policy Program Manager, SB/SE, Fraud/BSA, BSA Policy & Operations, Response to TAS Information Request (Oct. 14, 2005).

compliance.[60] Instead of auditing employer and employee tax returns for tip-related issues, which burdens employers, employees, and the IRS, the IRS negotiates TIP agreements with employers.[61] The TIP agreements generally increase the amount of tip income reported by employees who receive tips and the amount of employment taxes paid by employers on employee wages received as tips.[62] TIP agreements are generally used in the food and beverage, cosmetology, and gaming industries. There are two basic types: Tip Rate Determination Agreements (TRDAs) and Tip Reporting Alternative Commitments (TRACs).

Under a TRDA, the IRS and the business agree upon a tip rate for various occupations and at least 75 percent of the business' employees agree to report tip income at the agreed rate on their income tax return. Under a TRAC, the business educates all of its employees about their obligation to report tip income and establishes procedures to promote reporting. These agreements are attractive to businesses because the IRS generally will not audit prior year tip reporting compliance (by the business or its employees) while a TIP Agreement is in effect.[63] The IRS is currently a party to 16,697 TIP agreements, including 14,640 in the food and beverage industry, 1,683 in the cosmetology and barbering industry, and 374 in the gaming industry.[64]

- *Making it Easier to Pay Taxes Electronically or by Phone.* Taxpayers may use the Electronic Funds Transfer Payments System (EFTPS) to make estimated tax payments or deposits electronically or by telephone.[65] EFTPS makes it easier for all taxpayers, including cash economy participants, to pay their taxes. The IRS encourages taxpayers who pay depository taxes, such as employment taxes, to enroll in EFTPS by waiving one prior failure to deposit penalty for new enrollees.[66]

While the IRS says it plans to promote EFTPS, it has only been successful in encouraging taxpayers to use EFTPS for depository taxes, such as employment taxes, rather than

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60 SB/SE Strategy and Program Plan FY 2004 – FY 2005 21 (Sept. 25, 2003).

61 For useful background information about TIP agreements, *see* IRM § 4.23.7.3 (Mar. 1, 2003); IRS Pub. 1875, *Tips on Tips* (Apr. 2004); SB/SE Research, Brooklyn/Hartford, Project No. 01.08.004.03, *Update the Report on 'The Effect of Tip Compliance Efforts on Tip Reporting,'* (July 2003); General Accounting Office, GAO-03-378, *IRS Should Continue to Expand Reporting on Its Enforcement Efforts* 49 (Jan. 2003); Treasury Inspector General for Tax Administration, Ref. No. 2001-30-076, *Opportunities Exist to Improve the Tip Rate Determination and Education Program* (May 2001). One variation of a TRAC, called an Employer-designed Tip Reporting Alternative Commitment Agreement (EmTRAC) allows employers to modify the TRAC agreement.

62 Tips are treated wages for certain employment tax purposes. *See* IRC § 3121(q); Treas. Reg. § 31.3102-3.

63 *See* IRM § 4.23.7.3(4) (Mar. 1, 2003). *See also*, Tip Reporting Alternative Commitment (Sept. 16, 2004), *available at* http://www.irs.gov/pub/irs-utl/hairtrac.pdf.

64 Acting Sr. Ops. Advisor, Specialty Programs, SB/SE, Response to TAS Information Request (Oct. 18, 2005).

65 EFTPS is the Treasury's electronic remittance processing system for making federal tax deposits and payments. Once enrolled in EFTPS, a taxpayer may initiate electronic payments with a telephone call or by using a computer. *See* IRM Exhibit 3.0.273-2 (Jan. 1, 2005) and www.EFTPS.gov.

66 IRS Pub. 4048, *EFTPS: Special IRS Penalty Refund Offer for Businesses* (Feb. 2004).

for estimated tax payments.[67] In FY 2004, the IRS received 61 percent of all employment tax payments (and 95 percent of all employment tax dollars) through EFTPS, but in tax year 2004 it received less than one percent of all estimated tax payments (and less than one percent of all estimated tax dollars) through EFTPS.[68] The IRS may be focusing on depository taxes because it is required by law to use an electronic system to collect 94 percent of all such taxes.[69] No similar requirements exist for estimated tax payments.

What Else Can the IRS Do to Address the Cash Economy?

Create a Cash Economy Program Office to Coordinate Initiatives

The IRS should consider creating a cash economy program office to coordinate research, outreach, and compliance efforts aimed at improving income reporting compliance among cash economy participants. The Earned Income Tax Credit (EITC) Program Office coordinates EITC related activities.[70] It also measures the results of its initiatives and takes responsibility for ensuring that the program works as intended, even though it relies on many other parts of the IRS to achieve its goals.[71]

As with EITC initiatives, responsibility for initiatives that may improve income reporting by cash economy participants is dispersed throughout the IRS. For example:

- SB/SE's Bank Secrecy Act (BSA) program checks Form 8300 submissions for compliance with the BSA, but does not conduct the income tax examinations that may arise from those checks;
- SB/SE's Examination program conducts income tax examinations;
- SB/SE Office of Governmental Liaison, which is part of Communications, Liaison & Disclosure, coordinates information sharing agreements with states and localities;
- W&I Submission Processing, which is a part of Customer Account Services, administers EFTPS;
- SB/SE Stakeholder Liaison (formerly Taxpayer Education and Communication) is responsible for practitioner outreach and communications regarding EFTPS; and

[67] The SB/SE Strategy and Program Plan said that it planned to develop a national marketing campaign to promote EFTPS and receive 73 million payments, more than 61 percent of all payments, through EFTPS in FY 2005. *See* SB/SE Strategy and Program Plan FY 2004 – FY 2005, 20, 59 (Sept. 25, 2003).

[68] Senior Tax Analyst, Wage and Investment Division, Customer Account Services, Submission Processing, Response to TAS Information Request (Oct. 5, 2005).

[69] *See* IRC § 6302(h). Congress should consider expanding the statutory mandate. See Key Legislative Recommendation: Measures to Reduce Noncompliance in the Cash Economy, *infra*.

[70] *See, e.g.,* Treasury Inspector General for Tax Administration, Ref. No. 2002-40-020, *Better Controls Are Needed to Ensure Appropriated Funds Are Used to Improve the Application of the Earned Income Credit* (Nov. 2001).

[71] *See, e.g.,* Government Accountability Office, GAO-05-92, *Earned Income Tax Credit: Implementation of Three New Tests Proceeded Smoothly, But Tests and Evaluation Plans Were Not Fully Documented* (Dec. 30, 2004).

- SB/SE's Specialty Programs function administers TIP agreements.

In short, nobody at the IRS with the power to coordinate research, outreach, and compliance efforts takes primary responsibility for reducing underreporting among cash economy participants. As a result, the IRS sometimes overlooks tools that could play an important roll in improving compliance among cash economy participants. For example, according to a cross-functional IRS team, the IRS has not been using state audit reports consistently or effectively due to organizational changes and competing priorities.[72] Another potential consequence of such dispersed responsibility is that no single function within the IRS measures the impact of initiatives to reduce underreporting by cash economy participants. TIGTA and GAO generally agree that such measures would help the IRS to reduce the tax gap.[73]

Moreover, underreporting by cash economy participants probably represents more than one-third of the tax gap, whereas less than four percent of the tax gap is associated with EITC overclaims.[74] Thus, a cash economy program office may be justified on the basis that the EITC has a program office and the tax gap attributable to cash economy participants far overshadows the tax gap attributable to EITC claimants.

Obtain More and Better Research

The IRS needs research to show the most effective use of its resources after taking into account the direct and indirect effects of its activities on tax revenues.[75] In most cases, the indirect effects are probably greater than the direct effects. Assume, for example, that the IRS increases the rate at which it audits a cash-based industry like construction and conducts the audits effectively so that it discovers all unreported income. The indirect revenue gains resulting from these audits would probably exceed the direct gains by a large margin as word spreads throughout the industry that cash income is actually subject to tax and each industry participant realizes that the IRS is examining taxpayers just like him or her. IRS researchers have estimated that the indirect effect of an aver-

72 Memorandum from Director, Governmental Liaison & Disclosure, SB/SE for Area Managers, Governmental Liaison & Disclosure, Interim Procedures for Obtaining State Tax Audit Results While Revisions are Made to the Existing Implementing Agreements (Mar. 11, 2005).

73 *See, e.g.*, Government Accountability Office, GAO-06-208T, *Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance* (Oct. 26, 2005); Written Statement of Russell George, Treasury Inspector General for Tax Administration, *Hearing Before the Senate Committee on Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies, On the Internal Revenue Service's Fiscal Year 2006 Budget Request* (Apr. 7, 2005).

74 IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (June 7, 2005). Further, about 48 percent of all examinations involve EITC claimants, whereas only about nine percent of examinations involve non-EITC Schedule C filers. SB/SE, AIMS Closed Case Database, IRS Examination Table 37 (Apr. 2005). However, it is difficult to reconcile the number of EITC examinations with the EITC budget allowance. In FY 2004, the IRS allocated only about 5 percent of its tax law enforcement resources to EITC compliance. *See* IRS Doc. 9940, *Budget in Brief, Fiscal Year 2005* 4 (Feb. 2004); Treasury Inspector General for Tax Administration, Ref. No. 2005-40-133, *Administration of the Earned Income Tax Credit Program Has Improved, but Challenges Continue* 3 (Aug. 2005).

75 *See generally*, Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005).

age examination on voluntary compliance is between six and 12 times the amount of the proposed adjustment.[76]

However, not all audits have the same effect on compliance. A dollar spent auditing cash economy industries with high rates of noncompliance may have a very different effect than a dollar spent auditing corporate tax shelters. A dollar spent on an ineffective audit may actually have a negative effect on compliance if it teaches taxpayers that they will not be caught even if audited. On the other hand, a dollar spent on making it easier for taxpayers to comply with their tax obligations, for example by revising forms, improving EFTPS, and answering tax law questions, has a positive indirect effect on compliance.[77] The IRS does not have current research to show where the next dollar is best spent. We do not even know whether a dollar is best spent on enforcement or taxpayer service.[78] Thus, in the absence of better research, the IRS cannot make fully informed resource allocation decisions.[79]

Each taxpayer is compliant or noncompliant for a different reason, and a comprehensive approach to reducing the tax gap must recognize these differences.[80] Because unreported income from the cash economy is so difficult and costly for the IRS to detect and deter through traditional enforcement methods, the indirect effect of the IRS's activities is even more important in fostering compliance among these taxpayers than for the general population. Thus, research in this area is very important.

Revise Tax Forms

The IRS should revise Form 1040, Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, to include separate lines showing (1) the amount of income reported on

[76] Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35-36 (Oct. 1996); Jeffrey A. Dubin, Michael J. Graetz and Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax*, 1977-1986, 43 Nat. Tax J., 395, 396, 405 (1990).

[77] IRS researchers previously estimated that every dollar the IRS spent on return preparation generated $396 dollars of additional tax revenue. *See* Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 41 (Oct. 1996).

[78] For a more detailed discussion, *see* National Taxpayer Advocate 2004 Annual Report to Congress 211-225 (Most Serious Problem: IRS Examination Strategy); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Committee on Finance on The Tax Gap (Apr. 14, 2005); Statement of Nina E. Olson, National Taxpayer Advocate, before the United States Senate Appropriations Subcommittee on Transportation, Treasury, The Judiciary, Housing And Urban Development, and Related Agencies (Apr. 7, 2005). *See also* Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005); Treasury Inspector General for Tax Administration, Ref. No. 2005-10-159, *A Better Model Is Needed to Project the Return on Additional Investments in Tax Enforcement* (Sept. 2005).

[79] The Government Accountability Office has also recommended that the IRS obtain more and better research regarding the reasons that taxpayers fail to comply with the law. *See, e.g.*, Government Accountability Office, GAO-06-208T, *Tax Gap: Multiple Strategies, Better Compliance Data, and Long-term Goals Are Needed to Improve Taxpayer Compliance* (Oct. 26, 2005).

[80] For a discussion of the categories of taxpayer noncompliance, *see* Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003).

Forms 1099 and (2) other income not reported on Forms 1099. IRS research shows that taxpayers are more likely to report income that is reported to the IRS by third parties on information returns, such as Form 1099.[81] Some taxpayers appear to believe that income not reported on information returns is not subject to tax or at least that the IRS will not notice if they do not report it.[82] Separating out gross receipts on the income tax form would likely improve compliance by emphasizing to taxpayers that income not reported on information returns is still subject to tax. It may also suggest to taxpayers that the IRS will notice if they do not report any other income. Another benefit of such a revision is that it would allow the IRS to match the income reported on Schedule C with income reported on Forms 1099 more easily.

The IRS should also require all businesses (*e.g.*, sole proprietors, corporations and partnerships) to answer two questions on their income tax returns:

- Did you make any payments over $600 in the aggregate during the year to any unincorporated trade or business?
- If yes, did you file all required Forms 1099?

These two questions would alert uninformed taxpayers of their reporting obligations and encourage them to comply. The questions would also alert taxpayers that the IRS is looking at information reporting compliance and that there is additional risk to avoiding the information reporting requirements by paying contractors "under the table." Since taxpayers must sign tax returns under penalty of perjury, they may be hesitant to answer such direct questions inaccurately.

Increase Information Reporting and Withholding

Since we know that the compliance rate is approximately 96 percent when payments are reported to the IRS and 99 percent when payments are subject to withholding, increasing information reporting and withholding will decrease the amount of income that is not reported. The IRS has the authority to require payors to deduct and withhold tax from payments to payees under certain conditions, such as when a payee fails to furnish a valid Taxpayer Identification Number (TIN).[83] However, under current IRS procedures such backup withholding may not occur for a significant period.[84] The IRS should require mandatory backup withholding to begin more quickly when taxpayers provide an invalid TIN to the payor.

[81] IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001*, 22-23 (Feb. 24, 2004).

[82] *See* SB/SE Research – Brooklyn/Hartford, Project 01.08.003.04, *TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups* 9 (Dec. 2004).

[83] *See generally* IRC § 3406. A TIN may be a Social Security number (SSN) issued by the Social Security Administration (SSA), an Employer Identification Number (EIN), or an Individual Taxpayer Identification Number (ITIN).

[84] For a more detailed discussion, *see* Most Serious Problem: *Limited Scope of Backup Withholding Program, infra*. *See also* Treasury Inspector General for Tax Administration, Ref. No. 2001-30-132, *Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors* (Aug. 2001).

The IRS should explore the feasibility of entering into voluntary withholding agreements with businesses and their service providers.[85] Pursuant to a voluntary withholding agreement, a payor, a payee, and the IRS may agree that payments for services will be subject to withholding even if the payments are not wages. Unlike payments to independent contractors, payments to employees are subject to withholding and subject the payor to liability for employment taxes.[86] Businesses sometimes have difficulty determining if service providers should be classified as employees or independent contractors and the IRS often challenges such determinations.[87] The IRS could encourage taxpayers to enter into voluntary withholding agreements by agreeing not to challenge the classification of workers who are a party to such an agreement. These agreements could reduce both underreporting by payees and the controversy associated with worker classification.

Use Available Information

The IRS should use more of the information available from state and local governments, Forms 8300, and its audit selection tools to audit taxpayers who are operating in the cash economy and underreporting their income. Although the IRS has access to state and local tax information, reporting on large cash transactions and computer-based tools to identify underreporting, it used very few of these resources in FY 2005.[88]

Many states and localities impose business license taxes or require different classes of licenses, which are sometimes based on gross receipts.[89] The IRS should consider seeking access to business license tax filings and compare gross receipts, as reported on those filings, with gross income reported on the taxpayer's federal income tax return. This comparison could help the IRS identify businesses that may be underreporting income.

Many states and localities impose property taxes based on the value of real and personal property. The IRS should consider obtaining access to property tax records and comparing taxpayer property holdings with income reported on federal returns. Taxpayers whose property holdings are disproportionately large in comparison to the income

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85 *See* IRC § 3402(p)(3). The IRS may need to work with the Treasury Department to issue regulations before it can use this authority. For further discussion *see* Key Legislative Recommendation: Measures to Reduce Noncompliance in the Cash Economy, *infra*.

86 *See e.g.*, IRC §§ 3102(a), 3111, 3301, 3402.

87 One recent electronic search for cases citing Rev. Rul. 87-41, 1987-1 C.B. 296, which sets out a 20 factor test for determining whether a worker is an employee or an independent contractor, found 90 reported cases.

88 As noted above, in FY 2005 the IRS considered 1,092 state information items for examination potential, reviewed 2,366 Forms 8300, and closed 15,873 examinations of non-EITC Schedule C returns selected using UI-DIF.

89 *See, e.g.*, Fairfax County Code §§ 4-7.2-1 through 4-7.2-36 (2005) (imposing a Business, Professional and Occupational License (BPOL) tax based on gross receipts). *See also*, 18 VAC 50-22-10 (2005) through 18 VAC 50-22-270 (2005), *available at* http://www.state.va.us/dpor/Contractors%20Web.pdf (requiring contractors to obtain different contractor's license classes based on the value of the contractor's jobs).

reported on their federal income tax returns may be underreporting their income.[90] The IRS could use such information in conjunction with other factors to select returns for examination.

Educate Cash Economy Participants about the Benefits of Reporting

The IRS should do more to educate certain cash economy participants about the benefits of reporting their income. In addition to the satisfaction of obeying the law and avoiding potential civil and criminal penalties and interest charges, such benefits may include, for example, an increase in:

- Retirement benefits;
- Disability benefits;
- Survivors benefits;
- Medicare benefits;
- Access to credit;
- Earned income tax credits; and
- Ability to gain admission to the U.S. or a visa status adjustment for family members or employees.[91]

The IRS could test this concept by educating taxpayers through outreach and various media targeting cash economy participants in communities where compliance is low and such benefits are not well known.[92] Publicity about such benefits, when combined with other enforcement initiatives, may significantly improve reporting compliance in a given community.[93] The IRS could study the effect of such efforts to determine whether they are cost effective.

Reestablish Local Compliance Planning Organizations

Because tax compliance trends and norms are frequently local, it will be difficult for the IRS to effectively address them without local feedback about how its strategies are affecting taxpayers in a given community. The IRS needs such information and feedback so that it can adjust its strategy to effectively address local compliance issues. The IRS

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90 This screen should take into account a taxpayer's age as well as median income in the industry because older taxpayers or those who are retired would be expected to have property holdings that are disproportionate to their current income.

91 *See, e.g.*, Social Security, Survivors Benefits, Pub. No. 05-10084, 5 (Jan. 2005) (indicating that survivors benefits are based on average lifetime earnings); Social Security, What Every Woman Should Know, Pub. No. 05-10127, 1, 6 (Apr. 2003) (indicating that Medicare, death and disability benefits are based on earnings); IRC § 32 (Earned Income Tax Credit); 8 USC § 1182(a)(4) (requiring a sponsor to provide an affidavit of support for persons seeking admission to the U.S. or a visa status adjustment); 8 USC § 1183a (defining affidavit of support); Form 1-864, *Affidavit of Support Under Section 213A of the Act* (Oct. 5, 2001), *available at* http://uscis.gov/graphics/formsfee/forms/files/I-864.pdf (requiring sponsors to attach three tax returns to the Affidavit of Support).

92 The IRS already lists many of these benefits in an obscure publication for employers in the food and beverage industry. *See* Pub. 1875, *Tips on Tips 3* (Apr. 2004).

93 Joshua D. Rosenberg, *The Psychology Of Taxes: Why They Drive US Crazy, And How We Can Make Them Sane*, 16 Va. Tax Rev. 155, 227-232 (Fall 1996).

previously recognized the importance of a local response when it created local Compliance Planning Councils in the mid-1990s and gave them the authority to allocate local compliance resources and research.[94]

If noncompliance is so commonplace in a local market that the price of a good or service does not reflect tax compliance costs, suppliers may be unable to both pay their taxes and compete.[95] However, if the IRS could convince a critical number of market participants to report their income to obtain the benefits described above and avoid the risk of detection, then the market price for their goods or services would increase so that taxpayers could both compete and pay their taxes.

Just a few market participants usually cannot change the market price by themselves. Such a change generally requires collective action, which is difficult to achieve without some form of organization or a credible threat that the IRS will enforce the law.[96] If the IRS could focus its enforcement and educational efforts on a particular local market, however, it may be able to shift market prices and improve tax compliance among large numbers of market participants. As the IRS's activity starts to affect market prices, it could produce a dramatic increase in voluntary compliance in the local cash economy as it changes local norms.[97] A local planning organization could work to identify local compliance challenges, direct the IRS's local response, and measure its effectiveness. A national cash economy program office could replicate successful local strategies nationwide.

Make It Easy to Pay Estimated Taxes

The IRS should make it just as easy for taxpayers to make their estimated tax payments as it is to pay other bills.[98] Most other creditors send customers a bill to remind them when a payment is due and offer the option of paying via automatic monthly withdraw-

[94] *See* General Accounting Office, GAO/GGD-96-109, *Tax Research: IRS Has Made Progress but Major Challenges Remain* 30 (June 1996); IRS, District Office of Research and Analysis (DORA), *Phase I Training Material: IV. Framework; NORA, DORA roles* 8.

[95] *See, e.g.*, Joseph Bankman, *Tax Enforcement: Tax Shelters, The Cash Economy, and Compliance Costs*, 104 Tax Notes 185, 189 (July 12, 2004). IRS focus group discussions suggest that workers sometimes pass along much, if not all, of their tax "savings" from underreporting to their customers or employers. *See* SB/SE Research – Brooklyn/Hartford, Project 01.08.003.04, TEC Practitioner Focus Group Interviews, 2004 IRS Nationwide Tax Forums Emerging Issues Focus Groups 12 (Dec. 2004) (noting that workers will work for "half wages" if they are paid in cash).

[96] Interestingly, the author of a study on the cash economy concludes that unions may help to reduce the number of workers in the cash economy by formalizing employment conditions of informal workers. *See* Pascale Joassart-Marcelli & Daniel Flaming, *Workers Without Rights: The Informal Economy in Los Angeles*, Economic Roundtable Briefing Paper, 2002.

[97] *Accord* Jon S. Davis, et. al., *Social Behaviors, Enforcement, and Tax Compliance Dynamics*, 78 Acct. Rev. 39 (2003) (finding that noncompliant populations respond to increasing enforcement by gradually increasing compliance until enforcement reaches a threshold level, and then suddenly shifting to very high levels of compliance).

[98] The IRS could also make it possible for taxpayers to sign up for EFTPS and make a payment on the same day. Under its current process taxpayers must wait at least seven to 10 days to use EFTPS, even if they are in the "Express Enrollment" program. *See* Pub. 4276, *Express Enrollment Q & A's* (Jan. 2004). Taxpayers must wait two weeks if they do not participate in the "Express Enrollment" program.

als from the customer's bank account free of charge.[99] Similarly, the IRS could send letters to self-employed taxpayers each quarter to remind them to make their estimated tax payments. These reminders could point out that taxpayers can use EFTPS, a free service, to make estimated tax payments electronically or by phone and to schedule payments in advance, just like automatic payments to a mortgage lender or utility.[100] The letters should also offer to accept estimated payments monthly or even bi-weekly, just like most other recurring bills.[101]

Taxpayers may inadvertently fall behind on their estimated tax payments because the payment process is cumbersome. Estimated tax payments are due on the following oddly-spaced dates: April 15, June 15, September 15, and January 15.[102] These dates do not consistently coincide with calendar quarters, and some taxpayers do not believe the dates make sense.[103] It may also be difficult for taxpayers to save enough to pay their taxes on a quarterly basis. One study for tax year 1999 showed that 31 percent of the taxpayers who made (or were required to make) estimated tax payments were assessed estimated tax penalties.[104] A year 2000 telephone survey found that approximately two-thirds of taxpayers with a balance due prior to filing their return did not plan to owe a balance upon filing.[105] Taxpayers who want to comply with their estimated tax payment obligations sometimes fail because the process of estimating income, remembering odd payment dates, and saving enough money each quarter is cumbersome, especially for self-employed taxpayers who are juggling many different duties and many competing demands on both time and funds.

Anything that the IRS can do to help taxpayers make their estimated tax payments more easily and lessen the burden of saving to make such payments is likely to increase compli-

99 TIGTA previously recommended that IRS clearly communicate to taxpayers that EFTPS is free. *See* Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements*, 24 (Feb. 2004). This recommendation was based on a taxpayer focus group consensus indicating that taxpayers would not use credit cards to make estimated tax payments because credit card companies charge a convenience fee. *Id.*

100 Mortgage lenders often require borrowers to pay property taxes into escrow on a monthly basis to ensure that borrowers do not forget to make quarterly property tax payments or spend the funds elsewhere.

101 Some mortgage companies offer programs to electronically deduct mortgage payments bi-weekly rather than monthly.

102 Pub. 505, *Tax Withholding and Estimated Tax Payments*, 24 (Dec. 2004).

103 *See* Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 19 (Feb. 2004).

104 *See Id.*

105 *See* Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters 7* (Jan. 16, 2004), *citing W&I Customer Research Group 5, Causes and Potential Treatments for Underwithholding and Insufficient Estimated Payments* (2000).

ance.[106] A recent IRS study found that "investors" receiving reminder letters increased both estimated tax payments and withholding by a statistically significant amount.[107] The study recommended that the IRS consider a large scale "soft notice" program (*i.e.*, reminder letters).[108] According to IRS research, taxpayers who owe a balance upon filing their return are **more likely to understate their tax liability** than other taxpayers.[109] Moreover, more than 20 percent of such taxpayers with a balance due fail to pay it in full.[110] Self-employed taxpayers are often participants in the cash economy and need to make estimated tax payments. Thus, if the IRS could reduce estimated tax payment shortfalls it could increase both reporting and payment compliance by cash economy participants.

IRS COMMENTS

Create a Cash Economy Program Office to Coordinate Initiatives

The IRS does not agree that creating a Program Office would be an efficient way to address noncompliance in the Cash Economy. The analogy to the Earned Income Tax Credit (EITC) Program Office is misleading. The EITC population is comprised of wage earning taxpayers who, while not a homogeneous group, have many common issues that allow the IRS to segment and approach them with a coordinated and comprehensive strategy through a program office. The Cash Economy, as the National Taxpayer Advocate reports, is unknown in composition and size and, as a result, would be difficult to address in a similar fashion.

The IRS recently completed the first phase of the National Research Program (NRP) and the data is just becoming available for use. While the IRS believes that a comprehensive and well-coordinated strategy among the various IRS offices might be successful in addressing the issues of the Cash Economy, we must assess the magnitude of the problem and the characteristics of the population before deciding whether to create such a strategy. The SB/SE

106 Signing taxpayers up for EFTPS could make estimated tax payments almost as automatic as withholding. As previously noted, taxpayers subject to withholding report 99 percent of their income. IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001*, 22-23 (Feb. 24, 2004). For further discussion, *see* Key Legislative Recommendation: *Measures to Reduce Noncompliance in the Cash Economy, infra.*

107 *See* Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 6-7 (Jan. 16, 2004). The study defined "investors" as taxpayers with a balance due of between $100 and $10,000 with non-wage income in excess of $4,000 and wages of less than $500,000. *Id.* at 8.

108 Both GAO and TIGTA previously recommended that the IRS test a soft notice program to improve estimated tax payment compliance. *See* General Accounting Office, GAO/GGD-99-18, *Billions In Self-Employment Tax Are Owed* 8 (Feb. 1999) and Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements*, 19 (Feb. 2004) (recommending that IRS implement a soft notice for estimated tax payments and noting that although IRS planned to implement GAO's soft notice recommendation, it delayed and then canceled the planned implementation).

109 Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004).

110 *Id.*

Division will ask the IRS Office of Research, Analysis and Statistics to assist in that effort.

Obtain More and Better Research

The IRS agrees that based on available research, there appears to be an indirect benefit to compliance from audits. However, other than the recent Criminal Investigation-sponsored study, the existing estimates are dated. Data from the first phase of the NRP, which have just become available, might be used to update these estimates. To date, only estimates of direct benefits have been developed from NRP. Additional research to help determine with more certainty the audits with the greatest indirect benefit may be useful, but defining and building an accurate resource allocation model that actually measures indirect benefit would be difficult, if not impossible.

Revise Tax Forms

The IRS disagrees with the National Taxpayer Advocate's suggestion that the IRS should include a separate line on Form 1040, Schedule C, for the amount of income reported on Form 1099, *U.S. Information Return*. Currently, accounting systems ordinarily do not separate Form 1099 and non-Form 1099 income. Requiring all taxpayers to do so would be costly and burdensome, particularly for small businesses. In addition, the Form 1099 data is not required to process the tax return; asking for that information runs counter to the Paperwork Reduction Act.

Further, we believe a separate line would burden compliant taxpayers more than it would change the behavior of noncompliant taxpayers. If noncompliant taxpayers are not deterred from submitting an erroneous return by the penalty of perjury, it is unlikely that an additional line will cause them to list income they intentionally omitted elsewhere.

The National Taxpayer Advocate also suggests adding questions on Form 1040, Schedule C, to prompt information return filing. The instructions to Schedule C already inform taxpayers of the filing requirements for such returns and refer them to the General Instructions for Forms 1099, 1098, 5498, and W-2G, catalog # 11409F. These actions might improve compliance and enhance enforcement activities, but only if the taxpayer responds correctly on the forms. Otherwise, the IRS could verify the answers only upon audit.

Increase Information Reporting and Withholding

Payees may benefit by having more accurate information concerning their tax liability, but there is a trade off on the additional burden to payors where the law does not mandate reporting. In addition, there are many and substantial issues with voluntary withholding agreements. In part, the IRS is concerned about the resource impact of entering into voluntary withholding agreements with businesses and their service providers. We believe that we would have to significantly reallocate resources in the field in order to use voluntary withholding agreements effectively.

Use Available Information

The National Taxpayer Advocate recommends increasing the use of information from state and local governments, Forms 8300, and UI-DIF tools. Examiners have access to the information the National Taxpayer Advocate suggests. They use the information appropriate for the issues identified on the tax returns assigned to them for examination, including public record information such as real and personal property records.

Reestablish Local Compliance Planning Organizations

The IRS has in place a process for Areas to identify local non-compliant industry segments for audits. The process also requires alternative treatments, such as interaction with local chapters of national organizations and industry representatives. Further, the SB/SE Communications Liaison and Disclosure Division signs off on each Compliance Initiative Project, which permits the IRS to identify educational opportunities.

Make It Easy to Pay Estimated Taxes

The National Taxpayer Advocate suggests expanding and promoting EFTPS for estimated tax payments. These reminders are already part of EFTPS Online Version 3.0, which is under development and should be delivered no later than FY 2007.

TAXPAYER ADVOCATE SERVICE COMMENTS

Improving tax compliance in the cash economy is a difficult challenge. The National Taxpayer Advocate applauds the IRS's ongoing efforts and initiatives to address it. For example, although we have not seen EFTPS Online Version 3.0, if it truly makes paying taxes as easy as paying other bills it will be a significant step in the right direction.

RECOMMENDATIONS

However, the National Taxpayer Advocate recommends that the IRS seriously consider her other recommendations, discussed above, rather than summarily dismissing them. She recommends the IRS:

- Complete research into the magnitude of the cash economy noncompliance problem and characteristics of the taxpayer population involved before concluding that a cash economy program office would not be effective.
- Request additional research into the indirect effect of compliance activities before concluding that any such research could not be used to allocate resources.
- Study the National Taxpayer Advocate's proposed tax form revisions before concluding that they would not improve compliance.
- Test using voluntary withholding agreements before concluding that they are not practical based on resource constraints.
- Analyze how feedback from local Areas to the national office could be improved before concluding that the existing organization is superior to the organizational changes proposed by the National Taxpayer Advocate.

PROBLEM

TOPIC #4 **MOST SERIOUS PROBLEM: TRAINING OF PRIVATE DEBT COLLECTION EMPLOYEES**

RESPONSIBLE OFFICIAL

Kevin M. Brown, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

In July of 2006, the IRS will begin using private collection agencies to collect tax delinquencies under the authority granted to it by the American Jobs Creation Act of 2004 (AJCA).[1] The Private Debt Collection (PDC) initiative marks a dramatic departure from IRS collection practice and procedure and implicates many, if not all, of the taxpayer rights built into the federal tax laws and procedures relating to IRS collection practice.

Tax collection by private agencies raises several broad concerns, including the introduction of private contractors into an inherently governmental function,[2] the disclosure of private taxpayer information to non-governmental entities,[3] and the use of less highly trained employees in the collection process. However, as the IRS completes its PDC processes and procedures and works towards the July 2006 implementation date, one issue is paramount: the adequacy of training for private collection representatives.

ANALYSIS OF THE PROBLEM

Background: The Federal Tax Collection Environment

The landscape of federal tax debt collection has changed dramatically since 1996 when the IRS last attempted private debt collection.[4] Changes to the tax laws have established more protections for taxpayers while simultaneously creating a more complex tax collection system for the IRS to administer. These changes include:

- Independent reviews of any rejection of a proposed offer-in-compromise or installment agreement before such rejection is communicated to taxpayers, and appeal rights on the rejection or termination of installment agreements;[5]
- Collection Due Process (CDP) hearings which offer taxpayers a chance to obtain a hearing from an independent Appeals officer after the IRS places a lien on taxpay-

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[1] The American Jobs Creation Act of 2004, Pub. L. 108-357, Title VIII, § 881, 118 Stat. 1625 (2004).

[2] U.S.C.A. Const. Art. I § 8, cl. 1 confers the power to collect taxes upon Congress:

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

[3] *See* IRC § 6103 providing protections for the confidentiality and disclosure of tax returns and return information.

[4] The 1996 pilot private debt collection initiative was discontinued for multiple reasons, including that the revenue collected was less than the IRS's direct costs plus revenues lost from using IRS employees to support private collection rather than collect taxes. General Accounting Office, GAO/GGD-97-129R, *Internal Revenue Service: Issues Affecting IRS's Private Debt Collection Pilot 2* (July 18, 1997).

[5] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206 § 3462(a); now codified in IRC § 7122(d).

ers' property and before the IRS can first levy on taxpayers' property;[6]

- Expanded spousal relief available from joint deficiencies, including equitable consideration as a basis for relief;[7]
- The termination of certain taxpayer waivers of the running of the collection statute expiration date (CSED) as of December 31, 2002, thereby preventing the IRS from collecting certain accounts beyond this date;[8]
- Restrictions on productivity-based evaluations of IRS employees;[9]
- Prohibited conduct on the part of IRS employees;[10] and
- Establishment of the National Taxpayer Advocate position and reorganization of the Office of the Taxpayer Advocate, with the designation of at least one Local Taxpayer Advocate in each state to assist taxpayers with their IRS problems.[11]

These are merely a few examples of the complex changes in the law affecting tax collection. These legislative provisions also serve to illustrate the differences between the collection of federal tax debts and collection of ordinary consumer debts.

In FY 2005, the National Taxpayer Advocate assigned Taxpayer Advocate Service (TAS)

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[6] Pub. L. No. 105-206 § 3401(b), now codified in IRC §§ 6330 and 6320.

[7] Pub. L. No. 105-206 § 3201, now codified in IRC § 6015.

[8] IRC § 6502 provides that the IRS generally has 10 years from the date of assessment to collect tax. Certain actions by taxpayers either suspend or extend the collection statute of limitations, such as submission of an offer in compromise. IRC § 6331(i)(5) and 6331(k)(1). RRA 98 reduced the extent to which these waivers could be enforced, as follows:

> If, in any request to extend the period of limitations made on or before December 31, 1999, a taxpayer agreed to extend such period beyond the 10 year period referred to in section 6502(a) of the Internal Revenue Code of 1986, such extension shall expire on the latest of - -
> (A) the last day of such 10-year period;
> (B) December 31, 2002; or
> (C) in the case of an extension in connection with an installment agreement, the 90th day after the end of such period of such extension. Pub. L. No. 105-206 § 3461(c)(2).

The practical effect of this provision was to render unenforceable certain collection statute of limitations waivers as of December 31, 2002. For example, if an offer in compromise was submitted before December 31, 1999 and if a waiver of the collection statute of limitations extended the CSED to December 31, 2006, it would instead terminate on the earlier of the original 10-year collection period or December 31, 2002. For full discussion of the issue and how the IRS mistakenly calculated CSEDs for thousands of taxpayers, *see* National Taxpayer Advocate 2004 Annual Report to Congress 182.

[9] Pub. L. No. 105-206 § 1204.

[10] Pub. L. No. 105-206 § 1203, prohibiting the following conduct on part of IRS employees: willful failure to obtain approval signatures on documents authorizing the seizure of a taxpayer's home, personal belongings, or business assets; providing false statements under oath with respect to material matter involving a taxpayer or taxpayer representative; falsifying or destroying documents to avoid uncovering mistakes made by any employee with respect to a taxpayer or a taxpayer representative; assault or battery on a taxpayer or taxpayer representative; violation of a taxpayer's or taxpayer representative's civil rights; violations of the Internal Revenue Code, or regulations or policies, for the purpose of retaliating against or harassing a taxpayer or taxpayer representative; willful failure to file a federal tax return; willful understatement of a federal tax liability; threatening audit to a taxpayer to extract personal gain; or willful misuse or violation of IRC § 6103.

[11] Pub. L. No. 105-206 § 1102(a) and (c), now codified in IRC §§ 7803(c) and 7811.

staff to work with the IRS team designing the PDC initiative. Underpinning the justification for the PDC initiative is the belief that private collectors can effectively make contact with a high volume of taxpayers and resolve delinquent tax debts at least as efficiently as the IRS.[12] Thus, TAS participation was in part guided by the principle that private collectors should not be provided advantages in the collection process over the IRS at the expense of either taxpayers' rights or the long-term goal of increased rates of voluntary tax compliance. In other words, private collectors should be subject to the same limitations and restrictions as the IRS in the collection process and should be required to play on a "level playing field" with the IRS.[13]

We have only praise for the hardworking individuals in the IRS who seek to make the private collection effort successful under difficult time constraints. However, the current plan shortchanges taxpayers by exempting private collectors from the type of training required of IRS employees in similar functions. A review of the PDC process design demonstrates that private collectors will have broad interaction with taxpayers. The IRS has analogized the use of private collectors to the IRS Automated Collection System (ACS), where IRS collection representatives interact with taxpayers on the telephone. When taxpayers claim an economic hardship during collection efforts, ACS collection representatives must determine whether to designate the account "currently not collectible" or refer the case to TAS.[14] Thus, ACS collection representatives have the significant responsibility of deciding whether to take the first step in the process toward assisting a taxpayer experiencing a hardship. Like ACS employees, private collectors will be granted discretion on whether to take the important first step towards obtaining relief for taxpayers alleging hardship. Yet, the private collectors will not receive even a small fraction of the training that is given to the IRS employees in similarly situated positions. Moreover, the private collectors themselves will administer the PDC training.

PDC Process Design

The AJCA legislation placed some parameters around the PDC program by authorizing the IRS to contract with private collectors for specific activities, including:

- To locate and contact any taxpayer specified by the IRS;
- To request full payment from such taxpayer and if such request cannot be met by the taxpayer, to offer an installment agreement providing for full payment of such amount during a period not to exceed five years; and
- To obtain financial information.

In return for these services, the PDC will receive a fee not in excess of 25 percent of the

[12] 150 Cong. Rec. H8411-01, 109th Cong., 2nd Sess. (Oct. 7 2004).

[13] *Use of Private Collection Agencies to Improve IRS Debt Collection, House Committee on Ways & Means,* 108th Cong. (May 13, 2003) (statement of Nina E. Olson, National Taxpayer Advocate).

[14] IRM § 5.16.1.1; *see also* § IRM 5.8.1.6.

amount collected.[15]

The AJCA explicitly prohibits private contractors from:

- Committing any act or omission which IRS employees are prohibited from committing; and
- Utilizing subcontractors to provide quality assurance services, compose debt collection notices, or directly interact with taxpayers.[16]

The design of the PDC initiative and the scope of work to be performed by private collectors are set out in the IRS's procurement document, known as a Request for Quotations (RFQ), which solicits bids from private collectors to perform the work. An RFQ was issued in April of 2005 with the expectation that three private collection firms would be selected to begin work in January of 2006 in the first phase of the program. In subsequent phases of the PDC initiative, as many as ten private collectors may be used. A court challenge to the procurement process caused the RFQ to be reissued on October 14, 2005, and the IRS now expects to launch the PDC in or around July of 2006.

Case Selection & Referral

The PDC process described in the revised RFQ is very similar to that in the original RFQ. The IRS has created two new units that will play important roles: the Oversight Unit and the Referral Unit. The process begins with the Oversight Unit, which will retrieve and select a population of cases from the IRS's Unpaid Collections Assessment file.[17] Cases selected for private collection inventories meet certain criteria designed to maximize the likelihood of collection.[18] These cases will be sent to the Referral unit which will prepare the case files for delivery to the IRS contract representative (COTR), who will in turn deliver the cases to the private collectors. The IRS will then send notices to those taxpayers whose accounts are being transferred to inform them that assignment of the account has been made and notify them of the particular collection agency that received the assignment. The private collectors will then begin trying to contact taxpayers using the available contact information. If the information for a particular taxpayer proves out of date, the collector will use skip tracing techniques to locate the taxpayer.[19]

When a case is selected for the private collector inventory, most IRS collection efforts will cease. However, in the revised RFQ the IRS clarified that systemic offset and levy

15 Pub. L. 108-357, Title VIII, § 881; now codified in IRC § 6306.

16 *Id.*

17 As of December 2004, the IRS had $7.7 billion of tax debt classified as potentially available for the implementation of the Private Debt Collection Initiative. IRS, Request for Quotations, April 25, 2005, I-23.

18 In order to minimize disputes on the issue of whether the tax is owed, cases selected will be those where the taxpayer has filed a tax return or has made three or more payments on a compliance related assessment. *See* IRS Request for Quotations, ¶ J.4.3.1.

19 "Skip tracing" refers to utilizing various databases to detect current contact information. *See* IRS Request for Quotations, ¶ J.3.2.3.

programs will continue while the case is with private collectors.[20] Thus, while private collectors will not have the power to impose liens or levies, they will demand payment from taxpayers under current enforcement action.

Taxpayer Contact

Once the private collector establishes contact with the taxpayer, it will make a demand for payment of the outstanding tax liability. Within five days of contacting the taxpayer, the collection company must send the taxpayer a written notice about the debt, pursuant to the Fair Debt Collection Practices Act (FDCPA).[21] The FDCPA applies to the private collectors working on behalf of the IRS.[22] Therefore, at this point in the process, or any time hereafter while the account is in the possession of the private collection company, the taxpayer may write a letter to the IRS Referral Unit opting out of private debt collection by indicating that he or she refuses to pay the debt or wishes the debt collector to cease further communication.[23] After the IRS receives the letter, the private collector must stop communication with the taxpayer.[24]

Payment Demands & Installment Agreements

If the taxpayer continues to engage with the private collector, he or she may indicate an inability to immediately satisfy the debt. The private collector is then permitted to notify the taxpayer of the availability of installment agreements in which the taxpayer can satisfy the outstanding liability over 36 months. While the AJCA enables the IRS to accept installment agreements with repayment terms up to 60 months,[25] the IRS requires approval by the Referral Unit for any installment agreement longer than 36 months.

Like IRS collection personnel, private collectors will be able to approve taxpayers for installment agreements where the liability is up to $25,000 if the taxpayer has otherwise

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[20] *See* IRS Request for Quotations, ¶ J.4.3.4. The IRS has authority to impose a continuous levy on "any Federal payment other than a payment for which eligibility is based on the income or assets of the payee." IRC § 6331(h)(2)(A). Additionally, the IRS has the authority to offset against overpayments to the IRS amounts owed to other federal agencies, past-due family support obligations, legally enforceable state income tax obligations, or amounts owed with respect to other federal tax obligations. IRC § 6402.

[21] The Fair Debt Collection Practices Act (FDCA) applies to private collectors working on behalf of the IRS. See IRC § 6306. Pursuant to 15 U.S.C.A. § 1692g, all collectors are required to send written notices to taxpayers within five days of the contact giving notice of: (1) the amount of the debt; (2) the name of the creditor to whom the debt is owed; (3) a statement that unless the consumer, within thirty days after receipt of the notice, disputes the validity of the debt, or any portion thereof, the debt will be assumed to be valid by the debt collector; (4) a statement that if the consumer notifies the debt collector in writing within the thirty-day period that the debt, or any portion thereof, is disputed, the debt collector will obtain verification of the debt or a copy of a judgment against the consumer and a copy of such verification or judgment will be mailed to the consumer by the debt collector; and (5) a statement that, upon the consumer's written request within the thirty-day period, the debt collector will provide the consumer with the name and address of the original creditor, if different from the current creditor.

[22] IRC § 6306(e).

[23] 15 U.S.C.A. § 1692c(c).

[24] *Id.*

[25] IRC § 6306(b)(1)(B).

remained in filing compliance over the previous five years, and the terms of the agreement will fully satisfy the liability within three years.[26] In these cases, the IRS does not conduct an independent financial analysis of the taxpayers' ability to pay, and private collectors will also be exempt from performing such analyses. However, the collectors will be required to determine whether the taxpayer is in filing and payment compliance for those submitting proposed installment agreements for liabilities under $25,000. The taxpayers' filing and payment history will not be available to the private collectors, who will therefore need to rely on the verbal assurances of taxpayers that they are otherwise in compliance. If the IRS finds a taxpayer is not in compliance, it will not approve the installment agreement.[27]

If the proposed installment agreement is for a liability in excess of $25,000, the private collector is required to complete a financial analysis of the taxpayer's ability to pay and refer the analysis and the proposed installment agreement to the IRS Referral Unit for final approval. Private collectors will not be permitted to explore other collection alternatives that involve compromising the liability, such as offers in compromise.[28]

Inability to Pay & Economic Hardship

If, in response to a collector's demand for payment, the taxpayer alleges a financial hardship, the private collector is required to obtain the taxpayer's financial information over the phone on IRS Form 433-F, *Collection / Information Statement ACS*. However, the taxpayer can elect to send the financial information directly to the IRS. The financial information will be forwarded to the IRS Referral Unit for review and verification of the hardship. If the taxpayer's hardship condition is verified, the account will be returned to the IRS and designated as Currently Not Collectible (CNC) on the IRS's system.[29] In certain circumstances, the financial verification requirement is waived.[30]

Congress established the National Taxpayer Advocate, Taxpayer Advocate Service, and Local Taxpayer Advocates for the protection of taxpayers experiencing significant hardships, including delays, in their dealings with the IRS.[31] If taxpayers request TAS

[26] IRC § 6159(c) guarantees that installment agreements will be approved if the liability is $10,000 or less, the taxpayer has been in filing and payment compliance for the past five years, the liability will be satisfied within three years and the IRS determines that the taxpayer cannot immediately satisfy the liability. The Internal Revenue Manual also authorizes collection personnel to accept "streamlined installment agreements" up to $25,000 under the same general procedures without requiring verification of taxpayers' finances. IRM § 5.14.1.2.

[27] *See* IRS Request for Quotations, ¶ J.4.4.6.2.

[28] IRS Request for Quotations, 33, ¶ J.4.4.7.

[29] The provisions with respect to designating accounts as Currently Not Collectible are derived from existing IRS procedures. IRM § 5.16.1.1.

[30] No financial analysis is required of the taxpayer's claim of financial hardship if the liability is less than a certain threshold and one of the following conditions exist: the taxpayer has a terminal illness or excessive medical bills; taxpayer's only source of income is Social Security, welfare, or unemployment; or the taxpayer is unemployed with no source of income. This exception is contained in IRM § 5.16.1.2.9.

[31] Pub. L. No. 105-206 § 1102(a) and (c); now codified in IRC §§ 7803(c) and 7811.

MOST SERIOUS PROBLEMS

PROBLEMS

assistance from the private collector or describe circumstances suggesting that they are experiencing a significant hardship, the TAS telephone number (1-877-ASK- TAS1) will be provided and collection will pause for 30 days to give the taxpayer time to contact TAS. TAS will assist taxpayers with significant hardships and will interact with private collectors where necessary to ensure that the taxpayer understands all of his or her payment options or other alternatives for resolving the debt.

Complaint Process

The RFQ establishes a complaint process for taxpayers and their representatives.[32] When the IRS receives a written complaint from a taxpayer, the IRS will notify the collection contractor who must then cease collection activity and provide the IRS contracting representative (COTR) with a copy of the account history. The contractor may not resume collection activities until directed to do so by the IRS. The contractor must also provide any written complaints to the COTR by close of business the following day and must also provide notes of verbal complaints made by taxpayers. The contractor is required to keep a log of all complaints made by taxpayers, which will be accessible by the COTR and other parts of the IRS, including TAS.[33]

Once the IRS receives the complaints, the COTR will label the complaints as falling within three possible categories:

- Type One Complaints: These are complaints concerning rude behavior or incompetent performance. Type One complaints may, at the discretion of the IRS COTR, be re-categorized as Type Two Complaints.[34]
- Type Two Complaints: These complaints involve overly aggressive tactics by collectors that may involve intimidation but do not reach the level of statutory violations. Contractors are required to investigate the complaint and provide a report to the COTR.
- Type Three Complaints: These complaints involve violations of statutory protections of taxpayers, including the Fair Debt Collection Practices Act[35], the Privacy Act,[36] disclosure statutes,[37] Taxpayer Bill of Rights,[38] Taxpayer Bill of Rights 2,[39] and other applicable laws. Upon validation of Type Three Complaints by the

32 IRS Request for Quotations, 38-39 (¶ J.5).

33 *Id.*

34 Although the RFQ does not clarify the circumstances for when a Type One complaint could be reclassified as a Type Two Complaint, presumably this reclassification will occur when it appears that a particular collector is systematically incurring Type Two Complaints. *See* IRS Request for Quotations, 39 (¶ J.5.5.1).

35 15 U.S.C.A. § 1692 *et seq.*

36 5 U.S.C.A. § 552a.

37 IRC §§ 6103, 7213, 7213A, 7431.

38 Taxpayer Bill of Rights, Subtitle J of Title VI of Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, §§ 6226 – 6247.

39 Taxpayer Bill of Rights 2, Pub. L. 100-647, §§ 6226 – 6247 (1996).

COTR, the IRS will revoke all necessary clearances of the offending employee. The COTR is required to notify the Treasury Inspector General for Tax Administration of any validated Type Three Complaints.

An initial validated Type Two or Three Complaint will have no impact on the contractor, but subsequent Type Two or Type Three Complaints result in negative impact on the contractor's evaluation (as described below) and may also result in a monetary penalty depending on the type and number of validated complaints.[40] The IRS COTR has the authority to waive any repercussions to the contractor in certain situations.[41]

Payment, Private Collector Compensation and Performance

Private collectors are instructed to direct all payments to the IRS. Collectors will be paid commission fees based on dollars collected from assigned accounts, provided the IRS receives those payments 11 or more calendar days after the account was assigned.[42] The IRS will evaluate private collectors quarterly, based on a balanced metrics scorecard that measures:

- Percentage of dollars collected;
- Case resolution percentage;
- Taxpayer satisfaction;
- Employee satisfaction; and
- Validated complaints.[43]

The measures are not weighted equally, with the percentage of dollars collected counting towards 50 percent of the total measure and the remainder accounting for 12.5 percent each. The IRS has retained the ability to allocate cases among the various collection contractors according to the evaluation process. Therefore, it can reduce or eliminate altogether case allocations to collection enterprises that score unsatisfactorily compared to others.[44]

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40 The Validated Type Two or Three Complaint Deduction Schedule is as follows:

	Type II Complaints		Type III Complaints	
Cumulative Number of Occurrences	Balanced Metric Scorecard	Monetary Deduction	Balanced Metric Scorecard	Monetary Deduction
2	Deduct 2 points	$2,500	Deduct 4 points	$5,000
3	Deduct 4 points	$5,000	Deduct 8 points	$10,000
4	Deduct 8 points	$10,000	Deduct 12 points	$25,000
5	Deduct 12 points	$25,000	Deduct 24 points	$50,000
>5	Deduct 24 points	$50,000	Deduct 36 points	$75,000

See IRS Request for Quotations, Attachment 11.

41 The COTR may waive repercussions where the complaint was inadvertent, *e.g.* the result of a temporary systems problem, isolated incident, etc.

42 IRS Request for Quotations, 20.

43 IRS Request for Quotations, Attachment 1.

44 IRS Request for Quotations, Attachment 1.

TRAINING

In working with the IRS on the training initiative, TAS advocated training of private collection employees in two respects:

- Responsibility for providing training; and
- The scope and delivery of training topics.

The IRS acknowledges that our current federal tax collection system benefits from having expertly trained tax collectors engaging taxpayers.[45] Thus, the tax system may suffer to the extent that private collectors receive inadequate training.

Responsibility for Training

To create a level playing field between the IRS and private collectors and ensure that private collectors are taught by knowledgeable trainers, the IRS should assume responsibility for training collectors on core topics -- at least for the first batch of private collection employees, with videotapes of those initial sessions forming the basis of training for later hires. As designed, however, the PDC initiative assigns training responsibility on taxpayer rights and IRS procedures to the private collectors themselves, as follows:

> Prior to beginning work under this task order, the Contractor shall train all Contractor employees necessary to service the IRS program and any necessary subcontractor employees to ensure adherence to the Contractor's standard operating procedures, applicable laws and regulations, IRS policies, and the Private Debt Collection Agency Operations and Procedures manual issued by the IRS. The IRS required training will include training on issues related to taxpayer rights and PCA employee compliance with all applicable aspects of section 1203 of the Internal Revenue Service Restructuring Act of 1998.[46]

Thus, the training of private collection representatives will be left to the responsibility of the various private enterprises whose emphasis and attention to the details of taxpayer rights and other topics will vary from enterprise to enterprise. We are concerned that placing the responsibility for taxpayer rights training on the contractors will result in a lack of uniformity among various collection contractors in their approaches to and emphasis on such training.

Scope and Delivery of IRS Training

IRS employees receive substantial training before they handle collection matters. Table 1.4.1 below lists a small sample of the training required of entry level IRS employees.

45 National Taxpayer Advocate 2004 Annual Report to Congress 350.

46 IRS Request for Quotations, ¶ J.4.2.

TABLE 1.4.1, TRAINING FOR IRS UNITS REGARDING COLLECTION FUNCTIONS

IRS Function	Training Requirements
Automated Collection System (ACS)	**Training for New Hires** ◆ *ACS Basic Modules A-I (Training Course 6719-102):* Eight-week course in classroom setting for employees new to the ACS function emphasizing effective listening techniques and steps to completing successful interview. Materials include 1,393 page training document containing nine Modules (Introduction to IRS/ACS, IDRS Command Codes, ACS Systems, Communication Techniques, IMF Issues, BMF Issues, Administrative Enforcement Action, ACS Miscellaneous Case Processing and Adjustments). Three week on-the-job training is also offered to compliment the classroom training. ◆ *Training Publication 6602-102, Module B: Understanding the Rights of Taxpayers* (teaches nine lessons including Taxpayer Bill of Rights, the IRS Restructuring and Reform Act of 1998, and IRC § 6103 (privacy and confidentiality). **Mandatory Annual Training** ◆ *Unauthorized Access (UNAX) Training:* Provides training on requirements of IRS § 6103 and confidentiality and privacy of taxpayer information. ◆ *Ethics Awareness:* Scenario driven training to instill ethical behavior. ◆ *Computer Security Training:* Scenario driven training to instill protection of information and information systems. ◆ Annual Continuing Professional Education (CPE): CPE training was 24 hours in FY2005 and 8 hours of localized training.
Collection–Revenue Officers (RO)	**Mandatory Unit Training for New Hires (followed by on-the-job training)** ◆ *Orientation for Revenue Officers: Course 5610-112.* Taxpayer rights are introduced in revenue officer orientation with full explanation of Publication 1 (*Your Rights as a Taxpayer*). ◆ *Revenue Officer Training Unit 1 (1,117 pages):* Training Publication 5610- Module A: Taxpayer Rights. Other modules include Balance Due Accounts, Collection Information Statements (preparing and analyzing), Installment Agreements (guidelines, preparing, and monitoring). ◆ Units 2, 3, and 4 also emphasize taxpayer rights throughout, but focus on technical issues such as levies, summonses, seizures, criminal fraud, termination, and jeopardy assessments comprising 1,491 pages of course work. **Mandatory Annual Training** ◆ *Unauthorized Access (UNAX) Training:* Provides training on requirements of IRS § 6103 and confidentiality and privacy of taxpayer information. ◆ *Ethics Awareness*: Scenario driven training to instill ethical behavior. ◆ *Computer Security Training:* Scenario driven training to instill protection of information and information systems.
Field Assistance (FA)–Taxpayer Assistance Center	**Mandatory Unit Training for New Hires** ◆ *TRR Collection/ICS Training for Field Assistance* (Course 6521-102). The course contains an 897-page training document that introduces Field Assistance employees to compliance inventory work. Taxpayer rights issues are addressed throughout. Module F of the course is devoted to interviewing taxpayers. One of the modules covers how to conduct a Balance Due Interview. During this interview, employees will request full payment, conduct a compliance check, secure and analyze a collection information statement (CIS), determine the cause and cure of the delinquency and notify the taxpayer of enforced collection among other things. **Mandatory Annual Training:** ◆ *Unauthorized Access (UNAX) Training:* Provides training on requirements of IRS § 6103 and confidentiality and privacy of taxpayer information. ◆ *Ethics Awareness:* Scenario driven training to instill ethical behavior. ◆ *Computer Security Training*: Scenario driven training to instill protection of information and information systems.

Taxpayer Advocate Service (TAS)	***Mandatory Compliance with Case Advocate's Professional Development Plan: (selected courses are described below)*** ◆ *Case Advocacy – Collection Financial Analysis and Case Resolution;* ◆ *Balance Due Process; Collection – The Collection Organization Notice on Demand;* ◆ *Financial Analysis and Case Resolution;* ◆ *Interest-Based Interviewing Techniques;* ◆ *TAS Fundamentals, Part 2* (Courses 12079 through 12088) **Mandatory Annual Training:** ◆ *Unauthorized Access (UNAX) Training:* Provides training on requirements of IRS § 6103 and confidentiality and privacy of taxpayer information. ◆ *Ethics Awareness:* Scenario driven training to instill ethical behavior. ◆ *Computer Security Training:* Scenario driven training to instill protection of information and information systems. ◆ *Continuing Professional Education:* In FY 2005, this mandatory training involved more than 40 hours of course work in a classroom setting

In addition to the mandatory training provided to its employees, the IRS also provides an exceptional learning environment. With continuous access to experienced managers and the IRS Office of Chief Counsel, answers to complex tax questions are nearly always readily available.

In contrast to the types of introductory and continuing education received by IRS employees, private collectors will watch a video entitled "Safeguarding IRS Confidential Information" and a two hour training video with time allotted to 5 topics as follows:

- 20 minutes for "Privacy Awareness;"
- 20 minutes for "Disclosure & Safeguards Awareness;"
- 20 minutes for "Taxpayer Rights and the Taxpayer Advocate Service;"
- 20 minutes for § 1203 of the IRS Restructuring and Reform Act of 1998; and
- 20 minutes for "The Role of the Treasury Inspector General for Tax Administration.

Private collectors will also receive a handbook entitled "PCA Policies and Procedures Guide" on which contractors are to train themselves and a pocket guide entitled "IRS Disclosure and Awareness Pocket Guide for Contractors."

While it may not be feasible or necessary from a time or resource perspective to require private collectors to undergo the same amount of training as IRS employees, at a minimum, the IRS should offer classes on the following topics to collection contractor employees:

- **Taxpayer Rights:** This course would cover the development of taxpayer rights protections, including the Taxpayer Bill of Rights,[47] Taxpayer Bill of Rights 2,[48] and the IRS Restructuring and Reform Act of 1998.[49] Since taxpayers do not forfeit any rights by virtue of the PDC initiative, private collectors must be intimately aware of

[47] Pub. L No. 100-647, 102 Stat 3342 (1988).

[48] Pub. L No. 104-168, 110 Stat 1452 (1996).

[49] Pub. L. No. 105-206, 112 Stat. 685 (1998).

their obligations towards taxpayers. As described above, the IRS has planned for a 20-minute video presentation on taxpayer rights and the Taxpayer Advocate Service. Because the National Taxpayer Advocate believes this level of training to be inadequate, she has requested that the IRS allow her to augment the 20 minutes devoted to taxpayer rights with an additional two-hour video presentation. The IRS has agreed in principle to allow the additional taxpayer rights training.

- **Financial Information Interviews:** Private collectors will obtain financial information from taxpayers. While contractors may provide some financial training to their collection representatives, private collectors need instruction on Internal Revenue Manual procedures for the conduct of taxpayer interviews, including explanations of IRS Allowable Expense Guidelines, including deviations from the allowable national and local expense standards.[50]
- **Installment Agreements:** The installment agreement procedure to be utilized by private collectors corresponds to the IRS procedures for guaranteed and streamlined installment agreements, and thus, private collectors must be trained on IRS installment agreement procedures and scenarios.[51]
- **Confidentiality:** There are numerous provisions protecting taxpayers from disclosure of their tax return information to third parties.[52] A detailed review of legislative provisions protecting from disclosure of taxpayer information is essential to public confidence in the PDC initiative. This course should contain scenarios of various fact patters in addition to covering the technical requirements of these laws.
- **Liens & Levies:** The IRS will continue certain collection actions while the cases are on assignment to private collectors, and private collection representatives must be knowledgeable about the ongoing consequences of collection actions and aware of the rights and protections available to taxpayers subject to lien or levy.[53]
- **IRS Office of Appeals:** The Office of Appeals acts as an independent reviewer for many examination and collection actions taken by the IRS.[54] Taxpayers may request or may have already requested assistance from the Office of Appeals while the case is with private collectors. At a minimum, private collection representatives must understand at what point in the collection process taxpayers can seek the

50 IRM § 5.15.1.

51 IRM § 5.14.1.2.

52 IRC §§ 6103 (Confidentiality and disclosure of returns and return information); 7213 (Unauthorized disclosure of information); 7213A (Unauthorized inspection of returns or return information), and 7431 (Civil damages for unauthorized inspection or disclosure of returns and return information).

53 *See* IRS Request for Quotations, 20 (¶ J.4.3.4).

54 Pursuant to IRC §§ 6320 and 6330, the Office of Appeals administers Collection Due Process (CDP) hearings before levies and after the imposition of liens at which taxpayers may raise a number of issues, including spousal defenses, collection alternatives and the underlying liability (where the taxpayer has not received a notice of deficiency or otherwise had an opportunity to argue the liability). The Office of Appeals also administers the Collection Appeals Program, an administratively created program where taxpayers may obtain an independent review by Appeals of certain IRS collection actions. IRM § 8.7.2.

assistance of the Office of Appeals.

- **Taxpayer Advocate Service:** The AJCA provides that the Taxpayer Assistance Order (TAO) applies to private collectors.[55] TAS will work with private collectors on cases, and thus, collectors need familiarity with TAS authority and procedures. TAS has training materials and knowledgeable training staff ready to provide training in a classroom setting for private collection representatives.

Training on the Complaint Process

The Fair Debt Collection Practices Act contains a section devoted to Congressional findings about the debt collection industry in our country:

> There is abundant evidence of the use of abusive, deceptive, and unfair debt collection practices by many debt collectors. Abusive debt collection practices contribute to the number of personal bankruptcies, to marital instability, to the loss of jobs, and to invasions of individual privacy.[56]

This 1976 finding seems equally true today, if not more so. The Federal Trade Commission's most recent Annual Report on the Fair Debt Collection Practices Act disclosed that the Commission received 58,687 complaints from consumers about debt collectors in 2004, which are more complaints than had been received in any previous year and more complaints than had been previously received about any other industry.[57]

The process by which taxpayers can complain about the treatment from private collectors and by which collectors are held accountable is largely a matter of self-regulation to the extent that taxpayers make complaints to the collection contractor but do not send a copy of the complaint to the IRS.[58] Verbal complaints must be reduced to notes and kept in a complaint log that is submitted to the IRS contracting representative.

There are significant ambiguities in the Type One, Two, and Three Complaint descriptions. Type One Complaints (rudeness) trigger a different set of obligations on the contractor than Type Two (intimidation or heavy-handed behavior) or Type Three (statutory violations) complaints. For example, Type One Complaints do not require an immediate investigation by the contractor followed by a written report to the IRS contracting representative. On the other hand, Type Two and Three Complaints do require an immediate investigation by the contractor to be followed by a written report of the findings. Given the self-regulated nature of the complaint process, the IRS itself should

55 Pub. L. No. 108-357, Title VIII, § 881, 118 Stat. 1625 (2004); now codified in IRC § 7811(g). The authority for the National Taxpayer Advocate's Taxpayer Assistance Orders is provided for in IRC § 7811(a)(1)(A):

> The National Taxpayer Advocate may issue a Taxpayer Assistance Order if – (A) The National Taxpayer Advocate determines the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered by the Secretary.

56 15 U.S.C.A. § 1692

57 Federal Trade Commission Annual Report 2005: *Fair Debt Collection Practices Act* 2.

58 IRS Request for Quotations, 38 (¶ J.5).

train the contractors, with clear examples and case studies, on the types of complaints and their documentation requirements.

CONCLUSION

The Private Debt Collection initiative is a major departure from traditional IRS collection practice. There will need to be a significant adjustment in the minds of taxpayers to get accustomed to private collectors acting on behalf of the IRS. The IRS cannot afford to let the initiative diminish the respect that most U.S. taxpayers have for our tax system. The IRS has decided that it does not want to assume the obligation to train private collectors, even on subjects as central to the tax system as taxpayer rights. Erring on the side of too much training rather than not enough would be the most prudent strategy, at least at the inception of this initiative. Providing adequate training, especially on taxpayer rights and the complaint process, not only "levels the playing field" between the IRS and contractor employees, but also protects taxpayers.

IRS COMMENTS

The IRS regards the appropriate training of private collection agency personnel as critical to the success of this new program and has taken great care to craft a training program that will ensure the same level of proficiency for private collection agency (PCA) employees that is demonstrated by IRS employees. We are, however, in basic disagreement with the conclusions outlined in this Most Serious Problem reported by the National Taxpayer Advocate. While no PCAs have yet been awarded contracts, and no training has actually begun, we believe the content and delivery of IRS specific training material has been properly planned and will be executed in a highly professional manner by both the IRS and PCA personnel involved.

The procedures and processes for the implementation of private debt collection for federal taxes have been created so that the distinction is clear between the inherently governmental functions involved and the tasks to be performed by the PCAs. When contracts are awarded to the selected PCAs, the IRS will supply all materials outlined in the Request for Quotations (RFQ) issued October 13, 2005, and include a comprehensive handbook of procedures developed for use by the PCAs as well as specific documents and videos on: confidentiality of return information, privacy and safeguards, taxpayer rights, the Taxpayer Advocate Service (TAS), the application of the provisions of the Internal Revenue Restructuring Act of 1998, and the role of the Treasury Inspector General for Tax Administration. Documents developed for IRS employees on these subjects will be provided where available. In addition, based on discussions with TAS personnel, the IRS will also include a special video on additional TAS issues. These materials will include specific text and chapters on all necessary topics including data security, taxpayer rights, securing an installment agreement, accounts requiring special processing, recall and return of accounts and the complaint process. Supplying these materials is but the first step in working with the PCAs on a well-developed training plan. The PCAs are also required to submit a training plan for IRS approval. All of these documents will be used as the base for a class taught by the IRS for the instructors and key personnel designated by the PCAs. The IRS expects that topics of interest outlined by the National Taxpayer Advocate will be discussed in detail and the complexity of the materials will reflect appropriately the needs of the PCA employees in performing their assigned tasks.

This "train-the-trainer" session will be part of the pre-operational certification phase for the PCAs. The IRS plans to monitor the training provided by each firm to ensure that a quality presentation is made. All PCA employees working on this program will also be required to execute the same certifications of training required by IRS employees for critical topics. Support organizations within the IRS will be established to assist the PCAs in working the assigned inventories. IRS employees assigned to these units will be trained and available to work with the PCA employees as each case is worked to ensure the appropriate resolution is achieved. If on-the- job training needs are identified by either the IRS or a PCA, the support units will assist in delivering "just-in-time" training as needed. The IRS will monitor phone calls with taxpayers made by the PCAs and review casework; these review results will assist in identifying any additional training needs on an on-going basis. PCAs and their employees will be held to the same standards of service and rights protection as IRS employees and a customer satisfaction survey will be employed to track taxpayer feedback.

The depth of the interaction between a PCA employee and a taxpayer will not be analogous to a contact between an IRS employee and the same taxpayer. The IRS has designed the inventory selection to include only those cases whose attributes allow the type of case resolution intended by the statute. We have excluded cases that would require the additional knowledge of an IRS employee for resolution. When taxpayers claim an economic hardship, PCA employees will not be able to determine if an account can be designated "currently not collectible." They may only gather financial information and submit the case for an IRS employee to make a decision. The training designed for the PCAs is explicit in this regard. PCA employees will not require the same training as an IRS employee in many instances, and the training program has been tailored to reflect that reality. Complete training on referring cases to the Taxpayer Advocate Service is included in this program. The IRS related training is in addition to any conducted by each PCA on their own topics; most reputable PCAs routinely train their employees on many detailed topics including the provisions of the Fair Debt Collection Practices Act. As an additional note, PCA employees will be requesting payment from taxpayers whose outstanding liability will not be actively assigned within the IRS and meets the criteria for placement with the PCA. While a refund offset or systemic attachment to a governmental payment may occur on these cases, this would have occurred while the cases remain open, even if not assigned to the PCA.

The process for surfacing and tracking complaints from taxpayers has been constructed to provide multiple avenues of access by the taxpayer as well as several review points by the IRS to regulate compliance with the RFQ requirements. Clearly, one avenue of access is the PCA employee or manager who is required to track complaints. IRS monitoring of phone calls, case reviews, and a survey of taxpayers handled by the PCAs are intended to ensure that this avenue of identification functions properly. A second avenue of identification is the specific IRS support unit created to assist both taxpayers and PCAs in case resolution. A letter to each taxpayer assigned to a PCA is planned, and this letter will include a special telephone number for the support unit that the taxpayer can use to contact the IRS. This is in addition to the regular toll-free assistance, a third avenue. Fourth, TAS can also be contacted directly and that number will also be furnished to the taxpayers as part of the notifying letter. Training on the complaint process is included in the "train-the-trainer" session and the handbooks provided to the PCAs, but will also likely be part of a continuous dialogue with the vendor collection agency.

The PCAs that are awarded task orders for this program have already been awarded contracts under the GSA schedule. As a contract awardee, these companies are required to fully train their employees to fulfill the requirements of any task order. Second, while appropriated funds may be used for the training of contractors and other non-Federal employees where such training is necessary to the implementation of a Federal program, there is no requirement that the training be provided directly or via any other particular format such as the "train-the-trainer" or on-the-job. Also, the training program can be ongoing and require various actions to implement it over the course of its lifespan. It is within the discretion of the agency as to how to provide training necessary for the implementation of this program throughout the term of the PCA contract. In deciding how to train PCA employees, the IRS considered the potential cost of providing IRS employees to train each and every PCA employee both now and in the future as the PCAs hire new employees.

In conclusion, the IRS has assumed its responsibility for the success of the Private Debt Collection initiative, including the delivery of a quality, cost-effective training program for PCA employees on IRS specific issues. The IRS has instituted a comprehensive package of materials and planned an extensive process for training key PCA personnel in addition to several layers of review and feedback to ensure the appropriate handling of all cases assigned to private collection agencies.

TAXPAYER ADVOCATE SERVICE COMMENTS

We agree that there is a "basic disagreement" between the IRS and the National Taxpayer Advocate on the approach to training private debt collectors. The National Taxpayer Advocate reiterates her praise for all of the IRS employees who have participated in the development of the Private Debt Collection initiative. Thus, our concerns are not that the training efforts will lack professionalism. As indicated in the report, our concerns extend to the adequacy of the training delivery system and the scope of that training.

Train-the-Trainer

The Request for Quotations, *i.e.* the procurement document which solicited bids from

PCAs, does not reference the train-the-trainer concept in any way, and the IRS's comments above do not explain the nature and extent of this training in any detail other than to indicate that the foundation of the materials will consist of the two training videos and the PCA procedural guide provided by the IRS. Thus, there are few details about the train-the-trainer concept. We understand that the development of the training plan is still a work in progress.

However, we have fundamental concerns about utilizing a train-the-trainer methodology for the Private Collection Agencies (PCAs). In this report, we demonstrated that the business of federal tax collection has become eminently more complex over the last two decades with the passage into law of the Taxpayer Bill of Rights, the Taxpayer Bill of Rights 2, the Internal Revenue Service Restructuring and Reform Act of 1998 and other collection reforms. We do not believe the IRS can avoid this complexity through its inventory selection software. Moreover, the IRS has tax law experts in abundance, many of whom played important roles in the implementation of IRS procedures to conform to the changes in the laws. This type of experience cannot be passed on to trainers in the private collection industry (some of whom may possess no tax law expertise) in a short training session. There is no reason for depriving front-line collection employees (and the taxpayers who will have to deal with them) of this type of first-hand experience and expertise.

The IRS has indicated that it considered the potential cost of providing IRS employees to train each and every PCA employee both now and in the future as the PCAs hire new employees. However, we believe that more effective training methods may be less expensive (both in terms of out-front expenditures and in terms of the costs to our tax administration system of having poorly trained employees interacting with taxpayers) than what the IRS is proposing. For example, the IRS is proposing to have available "just-in-time" training for PCAs when deficiencies are spotted. We applaud this innovative idea. On the other hand, there are costs associated with having IRS teams on stand-by to provide just-in-time training that might not be needed if the IRS simply provided direct comprehensive training on the front-end of the process. Similarly, the IRS plans to have monitors present when the PCAs train themselves. If the IRS is going to incur the costs associated with having its personnel at training sessions, it may be more efficient to simply have IRS trainers present rather than monitors. In other words, the costs associated with correcting incomplete training may be eliminated or reduced if the IRS provided the training that is required of IRS employees.

Moreover, since first writing our initial analysis, we have learned there will be significant turnover among PCA employees working IRS accounts. That is, unlike IRS employees who work in the same collection positions for several years and reinforce their awareness, knowledge, and understanding of taxpayer rights through annual training and day-to-day practice, PCA employees will start and end their work on the IRS account on an ongoing basis. There will, in short, be no accretion of expertise or experience in protecting taxpayer rights specific to the Internal Revenue laws. More than any other aspect of the PCA initiative, this employee turnover poses serious risks to taxpayers and shows that the playing field is indeed not level between the IRS and PCAs. This turnover also increases the importance of the IRS conducting such training itself.

Scope

We believe the scope of the materials to be covered in PCA training is too narrow and should be expanded as recommended below. We are pleased that the IRS has agreed to include material about the complaint process in its train-the-trainer session. However, we again point out that ambiguities in the complaint process can best be addressed through scenario-driven training provided to the PCAs by IRS employees.

RECOMMENDATIONS

In consideration of the issues raised above, the National Taxpayer Advocate makes the following recommendations:

1. Expand the topics in the training materials to include topics on which IRS employees are required to be trained, including: financial information interviews, installment agreements, confidentiality, liens, levies, and IRS Office of Appeals. Additionally, PCA employees should be exposed to training on taxpayer rights and the Taxpayer Advocate Service that approximates the training received by IRS employees.
2. The IRS should provide the above-referenced training directly to the first group of PCA employees and utilize those resources currently dedicated to "monitoring" ongoing training sessions to instead conduct the training sessions.
3. If the IRS undertakes future procurements relating to its Private Debt Collection initiative, it should establish a monetary incentive on the contractor's scorecard to encourage the provision of additional training on taxpayer rights and other IRS related topics.

PROBLEM

TOPIC #5 **MOST SERIOUS PROBLEM: EARNED INCOME TAX CREDIT EXAM ISSUES**

RESPONSIBLE OFFICIAL

Richard J. Morgante, Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

In its efforts to improve the administration of the Earned Income Tax Credit (EITC), the IRS continues to focus on both EITC noncompliance by making improvements to the EITC examination process and providing education and outreach to ensure that eligible taxpayers are receiving the EITC. Despite significant improvements, however, problems remain for EITC examinations and recertification. These problems include EITC correspondence exams, which typically involve minimal personal interaction and can have negative consequences for low income taxpayers. Confusing IRS requests for information, lost taxpayer correspondence, lack of acknowledged correspondence, and a lack of personal contacts all contribute to problems for taxpayers in the EITC exam process.

Problems with the EITC exam process include:

- Delays in exam procedures;
- Taxpayer response rate; and
- Problems with documentation.

Problems with EITC recertification include:

- Delays in the recertification process;
- Inconsistent treatment of recertification cases; and
- Problems with documentation.

ANALYSIS OF PROBLEM

Background

In July 2002, the IRS took steps to improve EITC administration by creating the EITC Program Office.[1] The creation of the EITC Program Office allowed the IRS to create a comprehensive strategy for the administration of the EITC. In August 2002, the IRS established the EITC Advisory Council, a policy-making body responsible for providing strategy, budget, and operational reviews and recommendations for the Wage and Investment (W&I) Commissioner.[2]

[1] The IRS placed the EITC Program Office within the Wage and Investment Divisions (W&I). IRS, *Earned Income Tax Credit (EITC) Program Effectiveness and Program Management FY 2002 – FY 2003* iv (Aug. 8, 2003).

[2] The EITC Advisory Council includes executive level representatives from each IRS function responsible for administering the EITC and was designed to ensure an integrated strategic approach to EITC issues. IRS, *Earned Income Tax Credit (EITC) Program Effectiveness and Program Management FY 2002 – FY 2003* iv (Aug. 8, 2003).

In June 2003, Commissioner Everson announced a five-point initiative to improve service, fairness, and compliance with EITC rules.[3] The initiative was designed to:

- Reduce the backlog of pending EITC examinations to ensure that eligible taxpayers whose returns are being examined receive their refunds quickly;
- Minimize burden and enhance the quality of communications with taxpayers by improving the existing audit process;
- Encourage eligible taxpayers to claim the EITC by increasing outreach efforts and making the requirements for claiming the credit easier to understand;
- Ensure fairness by refocusing compliance efforts on taxpayers who claimed the credit but were ineligible because their income was too high; and
- Pilot a certification effort to substantiate qualifying child residency eligibility for claimants whose returns are associated with a high risk for error.

EITC Research Initiatives

The IRS has a number of projects underway to improve the EITC and address areas of the Commissioner's five-point initiative. One aspect of this program is a series of studies designed to examine the three major sources of errors identified in a 1999 EITC compliance study: qualifying child errors, filing status errors and income reporting errors.[4]

The primary initiative is the implementation of the EITC Qualifying Child Residency Certification Study (hereinafter referred to as certification).[5] The certification study looked at a random sample of 25,000 EITC claimants for whom the IRS could not establish qualifying child residency eligibility through available data.[6] The study sought to determine the impact of a residency certification requirement on:

- The amount of EITC claimed including the amount of erroneous claims;
- The number of children claimed;
- Taxpayer participation in the EITC;
- Taxpayer burden; and

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3 IRS, *IRS Announces Steps to Improve EITC Administration, Seeks Public Comment*, IR-2003-78 (June 13, 2003). The five-point initiative was the result of a Treasury-IRS joint task force formed in 2002 to study ways to improve the administration of the EITC. IRS, *Earned Income Tax Credit (EITC) Program Effectiveness and Program Management FY 2002 – FY 2003* 28 (Aug. 8, 2003).

4 *IRS, IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* (Oct. 2005). *See also* IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Feb. 28, 2002). The IRS recently issued the final report to Congress containing the findings for each of the three EITC studies.

5 The IRS conducted the first certification study during tax year 2003. The IRS conducted a second certification study during tax year 2004, with some modifications from the 2003 test. The results of the 2004 certification test are not yet available.

6 The 25,000 taxpayers in the test group were compared with a similarly sized control group with characteristics similar to the test group. IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 4 (Oct. 2005).

- The amount of erroneous claims that were prevented from being paid to ineligible taxpayers.[7]

Taxpayers selected as part of the certification study test group received a number of documents in December 2003, including Form 8836, *Qualifying Children Residency Statement*, which required proof of qualifying child residency in the form of records, a letter on official letterhead, or a signed affidavit.[8] Taxpayers could submit any combination of documents and the qualifying child residency requirement would be satisfied if the documents, when viewed together, showed the taxpayer and child lived together for more than half of 2003.[9] The certification study also included a follow-up survey, designed to learn how certification affected taxpayer compliance burden associated with claiming the EITC.

The IRS also engaged in an EITC Filing Status Study focused on taxpayers who improperly file as single or head of household, when they should have filed as married filing jointly or married filing separately.[10] The study examined the impact of requesting certain EITC taxpayers to document their marital status, to validate the filing status claimed on their tax return.[11]

The final study was an Automated Underreporter (AUR) Study to focus compliance efforts on taxpayers who claim the EITC but are either ineligible because their incomes are too high or are eligible but overclaim the EITC because they misreport their incomes.[12] The AUR Study used tax returns filed in tax year 2002 to identify, through document matching, EITC claimants with a high likelihood of income reporting errors. The focus of the study was to improve the method of selecting AUR cases to specifically address EITC overclaims due to misreported income.[13]

In December 2004, the Taxpayer Advocate Service released the EITC Audit Reconsideration Study, conducted by TAS and W&I. The EITC Audit Reconsideration

7 IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 5 (Oct. 2005).

8 For a more detailed discussion of the affidavit requirement, see *infra* notes 74-82 and accompanying text.

9 IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 7 (Oct. 2005).

10 *Id.* at 47.

11 *Id.* at 49. The EITC Filing Status Study looked at a random sample of 36,000 taxpayers who filed single, head of household, or married filing separately in tax year 2002 and had previously filed as married filing separately or married filing jointly at least once within the prior three years. If a taxpayer in the test group filed his or her return in tax year 2003 as single or head of household and claimed EITC with qualifying children, the taxpayer was required to provide additional documentation about marital status. During the period that the taxpayer's filing status was under examination, the EITC portion of the taxpayer's refund was frozen. Once the IRS confirmed filing status, the EITC was allowed and paid to the taxpayer.

12 *Id.* at 56. The Automated Underreporter Program is the automated analysis and processing of potential under-reported and/or over-reported tax return issues identified through information return matching. IRM § 4.19.3.1, Overview of IMF Automated Underreporter (Sept. 1, 2005).

13 IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* p. 56 (Oct. 2005). The study looked at a sample of 300,000 taxpayers, selected from the tax year 2002 AUR inventory, who claimed the EITC and for whom there were indications of income misreporting for tax year 2002. The returns selected for the AUR study had undergone initial processing months prior to the study, so the IRS did not hold the taxpayers' EITC while conducting the study.

Study focused on identifying ways to improve the accuracy and effectiveness of EITC audit reconsideration and the overall EITC correspondence exam process, while minimizing burden to taxpayers.[14] The results raised questions about the current audit reconsideration process and broader questions about the general EITC exam process.[15]

The IRS is currently engaged in a number of other research initiatives, the result of which may help improve the administration of the EITC, for both taxpayers and the IRS. In fiscal year 2004, TAS and the IRS Office of Research partnered to design a study to evaluate the impact of representation on the ultimate outcome of EITC audits.[16] The study will look at tax year (TY) 2002 EITC audit outcomes to determine if the presence of representation in an EITC audit increases the likelihood of a favorable outcome.[17]

TAS, the EITC Program Office and W&I Research are collaborating on a research initiative to collect information from EITC taxpayers to enable the IRS to better understand their customer service needs.[18] The first phase of the research consisted of focus group sessions with EITC claimants to determine and describe the most relevant EITC customer service issues.[19] The feedback from the focus groups will be used to design a survey that will be sent to a representative sample of all EITC claimants, the results of which will be used to recommend potential improvements in EITC customer service.[20]

Finally, TAS is also collaborating with the EITC Program Office and W&I Research on a study to identify the most significant barriers that taxpayers encounter during the EITC correspondence audit process. The IRS has conducted the first phase of the research, consisting of interviews with Low Income Taxpayer Clinic (LITC) representatives who have assisted taxpayers undergoing EITC correspondence audits.[21] The results from the interviews will be used to design a survey that will be sent to a representative sample of taxpayers who have recently experienced EITC correspondence audits to quantify the impact these barriers have on taxpayers. TAS will use the results of the study to recommend potential improvements to the EITC correspondence audit process.

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[14] For a detailed discussion of the study and its results, *see* National Taxpayer Advocate 2004 Annual Report to Congress vol. 2.

[15] For a more detailed discussion of the Audit Reconsideration Study, *see* discussion: *Approaches to Improving the EITC Exam Function, infra*.

[16] National Taxpayer Advocate Fiscal Year 2006 Objectives Report To Congress 37 (June 2005).

[17] *Id.* at 37-38. The target completion date for the audit outcome portion of the study is December 2005, but some results for cases in Appeals or litigation may not be available for reporting.

[18] *Id.* at 38-39.

[19] Wage and Investment, *Identifying EITC Taxpayer Customer Service Needs Report*, Research Project 6-05-12-3-018E (Oct. 18, 2005).

[20] TAS is currently working with W&I Research to develop the survey that will be conducted in early 2006.

[21] Taxpayer Advocate Service, *Challenges for Taxpayers Claiming the Earned Income Tax Credit (EITC), From Interviews with Low Income Tax Clinics* (Sept. 2005). The Low Income Taxpayer Clinic (LITC) Program is a grant program under IRC § 7526 where qualified organizations receive matching federal grants to represent taxpayers in controversies before the IRS or provide tax outreach and education to English as a second language (ESL) taxpayers.

EITC Exam Improvements

The IRS has also made a number of improvements to the EITC exam process over the past few years. Previously, the IRS sent one letter that denied the EITC claimed on the tax return, asked the taxpayer to substantiate the EITC, and triggered the opportunity for the taxpayer to appeal his case to the Office of Appeals.[22] This combination letter was very confusing for many EITC taxpayers who did not understand that they needed to preserve their appeal rights even though they were not yet sure whether the IRS would accept the information they submitted to substantiate their EITC claim.

Beginning in fiscal year 2005, the IRS eliminated the combination letter. Taxpayers subject to an EITC correspondence exam now receive two separate notices regarding the examination of their EITC claim. The first notice informs the taxpayer that their EITC claim is under examination and requests information to substantiate the EITC claim. If the taxpayer fails to respond to the first notice, or if the information provided is insufficient to substantiate the EITC, the taxpayer receives a second, 30-day letter. The 30-day letter disallows the EITC and gives the taxpayer the opportunity to appeal the IRS' decision.

In conjunction with eliminating the combination letter, the IRS has also created a new Publication 3498-A, *The Examination Process (Examinations By Mail)*. This new publication outlines the correspondence exam process and provides an Appeals request tear off form that the taxpayer can use to request an appeal of an IRS decision.

Prior to January 2004, when a taxpayer was subject to an EITC exam, the IRS froze the taxpayer's refund until the exam was complete. Beginning in January 2004, W&I changed its processes and limited the frozen amount only to the EITC portion of the taxpayer's refund.[23]

The IRS has also made significant progress by training correspondence examination employees to exercise judgment in evaluating the documentation taxpayers provide in a correspondence exam. In determining whether to allow or deny an EITC claim, IRS employees are encouraged to use judgment, based on the facts of the case and the information available, to determine whether to allow a taxpayer's claim in whole or in part. This focus on using sound judgment is beneficial in cases where a taxpayer is able to provide some documentation to support the claim, but is unable to obtain documentation for all bills and expenses.

Despite the progress made in the past few years, there is still room for improvement, especially in light of the recent EITC research.

[22] For a detailed discussion of the combination letter, *see* National Taxpayer Advocate, 2003 Annual Report to Congress 87-98.

[23] IRM § 4.19.1.5.5, *Dependent Database* (Apr. 07, 2005).

EITC Correspondence Examination Process

The IRS's Revenue Protection Strategy (RPS) guides the processing of most tax returns selected for EITC Correspondence Examination.[24] Under the RPS, the IRS generally freezes a taxpayer's EITC claim until the exam is complete.[25] Once the IRS selects a tax return for a correspondence exam, the IRS sends the taxpayer a series of letters with information requests, and the case continues through an automated batch process.[26]

A correspondence exam begins with the IRS sending the taxpayer an initial contact letter explaining the audit process and the issues the IRS is examining, and requesting documentation specific to these issues.[27] The IRS generally gives a taxpayer 30 days to respond to the initial letter. If the taxpayer sends documentation, and the IRS determines it is inadequate, the taxpayer receives another letter requesting additional information.[28] If the IRS receives documentation from a taxpayer but is unable to review it timely, the IRS generally sends an interim letter acknowledging receipt and giving a reply date.[29]

If the taxpayer does not respond to the initial contact letter within the given period, the IRS issues a second letter, commonly referred to as the 30-day letter. The 30-day letter includes an examination report showing the tax liability resulting from the adjusted issues. The taxpayer has the opportunity to send documentation to the IRS to verify the issues, agree with the exam report, or appeal the tax by returning a form included in the mailing.

If the taxpayer does not respond to the 30-day letter, the IRS issues a Statutory Notice of Deficiency, known as the 90-day letter. The taxpayer has 90 days from the date of this notice to petition the United States Tax Court.[30] If the taxpayer does not respond

[24] IRM § 25.12.1.5, *Revenue Protection Strategy* (Dec. 01, 2000). The revenue protection strategy is a program developed to focus on problematic tax returns and is built on a four-pronged approach to address the returns: Understanding, Prevention, Detection, and Enforcement.

[25] IRM § 4.19.1.5, *EITC/Revenue Protection Strategy* (Oct. 1, 2001). Prior to January 2004, a taxpayer's entire refund was frozen until the exam was complete. Beginning in January 2004, at the urging of the National Taxpayer Advocate (NTA) and others, the frozen amount is limited to the EITC portion of the taxpayer's refund. The NTA commends W&I for addressing this issue so quickly.

[26] IRM § 4.19.1.12, *Batch Processing Overview* (Oct. 1, 2004). Batch Processing is an IRS-developed, multifunctional software application that fully automates the initiation, aging, and closing of certain EITC and non-EITC cases. Using the Batch System, Correspondence Exam can process specified cases with minimal to no tax examiner involvement until a taxpayer reply is received. Because the batch system will automatically process the case through creation, statutory notice, and closing, tax examiner involvement is eliminated entirely on no-reply cases. Once the IRS considers a taxpayer reply, in most instances the case can be reintroduced into Batch Processing for automated aging and closing.

[27] A correspondence examination (audit) is handled through written correspondence (rather than a face-to-face meeting), normally can be completed in a few hours, is limited in scope to a few issues and does not include a review of detailed account records.

[28] IRM § 4.19.1.4.9, *Taxpayer Replies* (April 25, 2005).

[29] *Id.* If a reply is thirty days old or older, then an acknowledgement letter is sent advising taxpayer that a reply was received and an answer will be issued within thirty days. IRM 4.19.1.4.10, *Monitoring Overage Replies* (Jan. 1, 2001). When possible, all correspondence should be addressed before a statutory notice of deficiency is issued to a taxpayer.

[30] IRC § 6213.

to a notice of deficiency, the IRS will close the case and assess the taxpayer's account for the tax, interest, and any penalties. Because the Batch Processing system automatically moves cases through creation, statutory notice, and closing unless the IRS receives a taxpayer response, the taxpayer's failure to respond to any of the IRS' letters leads to the correspondence examination closing with no involvement from an IRS examiner.[31]

EITC Examination Statistics

In TY 2003, over 21 million taxpayers received the EITC.[32] In FY 2004, the IRS closed nearly 445,000 EITC correspondence exams.[33] Table 1.5.1 shows the results of these cases, with approximately 40 percent closing as a "no response" or "undeliverable," meaning that, according to the IRS examiners, the taxpayer did not contact the IRS with respect to the exam. The table also shows that approximately 17 percent of the exams close as "Default with Correspondence," meaning taxpayers attempted to engage in the audit process but left the system.

TABLE 1.5.1, BREAKDOWN OF EITC CORRESPONDENCE EXAMS BY TYPE OF CLOSURE

Fiscal Year 2004 EITC Return Closures[34]

Type of Closure	Number of Cases	Percentage of Total
No Response[35]	154,460	34.7%
Undeliverable[36]	25,616	5.8%
No Change without Adjustment[37]	76,659	17.2%
No Change with Adjustment[38]	20,258	4.6%
Agreed[39]	89,122	20.0%
Appealed/Petitioned[40]	4,377	1.0%
Default With Correspondence[41]	74,408	16.7%
TOTAL	**444,900**	**100%**

31 IRM § 4.19.1.12, *Batch Processing Overview* (Apr. 7, 2005). These cases are referred to as no-reply or no response cases.

32 For TY 2003, approximately 21.4 million taxpayers received the EITC, for a total of over $38 billion in EITC claims. These numbers are current through July 19, 2005 and do not account for all TY 2003 EITC claims. EITC Factsheet, TY 2001, 2002, 2003 returns (updated July 19, 2005).

33 AIMS Closed Case Database (Correspondence audit defined by using Employee Group Codes for Campuses, Disposal Codes, and Technique Codes 2, 6, or 7).

34 AIMS Closed Case Database W&I and SBSE (Correspondence audit defined by using Employee Code for Campuses, Disposal Codes, and Technique Codes 2, 6, or 7 listed by Disposal Code).

35 Disposal Code 10 and Technique Codes 6 & 7.

36 Disposal Code 13.

37 Disposal Code 2.

38 Disposal Code 1.

39 Disposal Codes 3, 4, 8, 9 & 12.

40 Disposal Codes 7 & 11.

41 Disposal Code 10 and Technique Code 10.

When EITC correspondence exams are combined with all other types of EITC examinations, EITC taxpayers have a much higher audit rate than other groups of individual taxpayers.[42] In FY 2004, the IRS examined 1,007,874 individual tax returns and of the returns examined, 48 percent – or 487,461 returns – contained EITC claims.[43] In comparison, only 17 percent of **all** individual returns filed contained an EITC claim.[44] Table 1.5.2 shows the IRS audit coverage for different groups of taxpayers, including EITC taxpayers.

[42] The non-correspondence EITC audits include Small Business/Self-Employed (SB/SE) and W&I office and field audits.

[43] IRS, *Data Book 2004*, Table 10, Examination Coverage. See Footnote 7 (Total Individual income tax returns examined 1,007,874, includes 487,461 returns examined with an earned income tax credit claim). These numbers do not include Automated Underreporter (AUR) EITC cases, they are listed as other compliance contacts. EITC Exam, however, is now tracking the 300,000 cases that are part of the AUR EITC Proof of Concept test.

[44] Statistics of Income, Tax Year 2002 Complete Data, Table 4 – 2002, Individual Income Tax Returns with Earned Income Credit, by Size of Adjusted Gross Income., for TY2002 - 21,703,187 million returns filed with Earned Income Tax Credit claimed and Table 1.–2002, Individual Income Tax, All Returns: Sources of Income and Adjustments, by Size of Adjusted Gross Income – 130,076,443 individual returns were filed in TY 2002 (21.7 million / 130.1 million = 16.7 percent).

TABLE 1.5.2, IRS AUDIT COVERAGE, FY2004[45]

Type of Return	Number of Returns Filed CY2003	Number of Returns Examined FY2004	Percentage of Returns Examined
All Individual Income Tax Returns	130,134,277	1,007,874	.77%
Individual Income Tax Returns with EITC claimed	**21,703,187**[46]	**487,461**	**2.25%**
Non-Business Income Tax Returns with Total Positive Income (TPI)[47] of $50,000 – $99,999[48]	25,616,486	113,944[49]	.44%
Non-Business Income Tax Returns with Total Positive Income (TPI) of $100,000 or more[50]	10,927,511	151,969[51]	1.39%
Individual Income Tax Return with a Business, Schedule C, Total Gross Receipts of $100,000 or more	2,101,144	39,124[52]	1.86%

DELAYS IN EXAM PROCEDURES

One of the major issues with the EITC examination function is that taxpayers experience long delays during the exam process. The IRS has made a number of efforts to clarify the correspondence sent to taxpayers as part of the process, but many taxpayers are still unsure why the IRS is contacting them and what information they need to provide to the IRS. The average cycle time of EITC exams for FY 2005 is 181 days.[53] The cycle time has continued to improve over the past few years and is down from 220 days in FY 2002, 203 days in FY 203, and 185 days in FY 2004.[54] The reduction

[45] Table shows selected income categories. IRS, *Data Book 2004*, Table 10, Examination Coverage, includes returns examined by Tax Examiners (by way of correspondence), Tax Auditors, and Revenue Agents. Correspondence exams account for approximately 80% of the individual return audits. This chart does not include the 768,036 EITC math errors that do not result in an examination, IRS *Data Book 2004*, Table 26.

[46] Statistics of Income, Table 4 – 2002, Individual Income Tax Returns with Earned Income Credit, Tax Year 2002 Complete Data, by Size of Adjusted Gross Income.

[47] Total Positive Income (TPI) is, in general, the sum of all positive amounts shown for the various sources of income reported on the individual income tax return and, thus, excludes losses. These are non-business returns.

[48] These are non-business returns.

[49] Approximately 1,400 of the returns examined in this class of taxpayers also had an EITC claim. The number of EITC returns filed within this class was approximately 13,500 resulting in an audit rate of 10 percent for the EITC returns within this class. Source: MACS Processing Year 2003

[50] These are non-business returns.

[51] Approximately 400 of the returns examined in this class of taxpayers also had an EITC claim. The number of EITC returns filed within this class was approximately 1,300 resulting in an audit rate of 30 percent for the EITC returns within this class. Source: MACS Processing Year 2003.

[52] Approximately 3,600 of the returns examined in this class of taxpayers also had an EITC claim. The number of EITC returns filed within this class was approximately 268,000 resulting in an audit rate of 1.3 percent for the EITC returns within this class. Source: MACS Processing Year 2003.

[53] W&I Reporting Compliance, *PMA Stoplight Measures Report: (Cycle Time EITC)*. FY2005 is through August 2005. Tax Reporting Compliance – Electronic/Correspondence Examination – PAC-7F. Service Center Exam cycle time is the average number of calendar days from the start of an examination (Status 10 or higher) to closure and includes returns where EITC was disallowed. The cycle time for "no change" cases was 135 days, but other dispositions may still result in the retention of at least some EITC.

[54] W&I Reporting Compliance, *PMA Report: Exam EITC Measures September 04*.

in average cycle time for EITC exams is a significant improvement on the part of W&I Compliance, particularly in light of the fact that the IRS has recently added days to the exam process by eliminating the combination letter. Despite this progress, however, 181 days is still a long time for taxpayers who need the EITC funds at issue in the exam.

While the somewhat lengthy cycle time can be frustrating for taxpayers, increasing cycle time is not always a negative thing when it allows the taxpayer additional time to respond to IRS requests. The IRS designed the 2004 certification test to give taxpayers sufficient time to respond to IRS requests. The certification process included both an additional letter and extra time that are not part of standard IRS procedures for EITC examinations.[55] IRS standard procedures allow taxpayers 30 days to respond to the report of proposed changes. The IRS extended this timeframe to 45 days for certification. The IRS also sent a second letter and report of proposed changes – which is not standard procedure – to taxpayers who did not respond to the first letter. This additional letter could add up to 45 days to the process. These two procedural changes added an extra letter and up to 60 days to the process.

Although the changes in the certification study added days to the cycle time for an EITC audit, the changes were designed to ensure taxpayers have adequate time to respond to IRS requests and provide adequate documentation to support an EITC claim. It is unclear whether the additional letter and time increased a taxpayer's ability to meet IRS requests. We recommend further study of whether an increase in cycle time improves a taxpayer's ability to prove EITC eligibility.

When a taxpayer responds to the IRS's request for documentation for an EITC examination, the taxpayer often encounters a new set of problems. The IRS may not associate these documents with the taxpayer's case and may ultimately misplace the documents. For FY 2004, the W&I received nearly 215,000 pieces of mail associated with EITC examinations.[56] At the end of FY 2004, almost 43 percent of the total EITC mail at the W&I campuses was characterized as overaged.[57] The taxpayer often must resubmit the documentation, some of which he or she no longer possesses because the taxpayer sent originals to the IRS.

A review of TAS cases through the Taxpayer Advocate Management Information System

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[55] IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 9 (Oct. 2005).

[56] W&I Reporting Compliance, *PMA Stoplight Measures Report: Mail EITC FY2004.* This represents the sum of the total mail at each FY 2004 month end. The EITC Audit Reconsideration study found that, on average, taxpayers submitted four different documents in connection with their case. National Taxpayer Advocate 2004 Annual Report to Congress vol. II at 21.

[57] W&I Reporting Compliance, *PMA Stoplight Measures Report: Mail EITC.* At 9/30/04, Total Mail was 17,080 of which 7,289 (or 42.7 percent) was overaged. The range of overage mail was as high as 76.7 percent for October 2003 and as low as 1.5 percent for April 2004. The overall average for all months combined was approximately 28 percent overaged. Overaged is defined as Status 55 (taxpayer correspondence unanswered for more than 30 days) and Status 57 (taxpayer correspondence unanswered for more than 60 days).

(TAMIS)[58] shows the problems associated with the IRS' untimely processing of EITC examinations. In FY 2005, 48 percent of all EITC Revenue Protection Strategy (RPS) cases came into TAS because of a delay in the exam process. This is an improvement over prior years, as 52 percent of RPS cases in FY 2004 and 61 percent of RPS cases in FY 2003 came into TAS due to delay. Table 1.5.3 shows that TAS accepted the majority of these cases because the taxpayer experienced a delay of more than 30 days in resolving an account problem or had not received a response or resolution to their problem or inquiry by the date promised.[59] Although these problems may seem trivial, their effect on taxpayers is significant.

TABLE 1.5.3, TAS EITC REVENUE PROTECTION STRATEGY RECEIPTS – PRIMARY ISSUE CODE 630 (CRITERIA CODE 5,6)[60]

Period	Total Case Receipts	Cases with a Delay of Over 30 Days (CC 5)	Cases Without a Response or Resolution by Date Promised (CC 6)	Total Criteria Code 5 & 6 Case Receipts	Percentage of Criteria Code 5 & 6 Case Receipts
FY 2003	25,977	9,340	6,424	15,764	61%
FY 2004	12,690	3,726	2,832	6,558	52%
FY 2005	8,599	2,215	1,912	4,127	48%

One tax practitioner provided TAS with an example of the effect of the IRS's processing delays on taxpayers. The practitioner reported that when his clients receive correspondence from the IRS, he promptly sends all required documentation and a power of attorney (POA) form with a return receipt requested. The practitioner receives no response from the IRS and a few weeks later, his client receives a Statutory Notice of Deficiency, indicating the taxpayer never responded to the request for documentation.[61] When the practitioner contacts the number on the deficiency notice, he is informed that the IRS is unable to speak with the practitioner without a POA and there is no POA on file because the package he sent to the IRS weeks before was never associated with his client's file. In this case, the IRS's inability to timely process documentation submitted

58 The Taxpayer Advocate Management Information System (TAMIS) is a TAS database exclusively dedicated to the recording, control, and processing of TAS taxpayer cases and to the capturing and analysis of core tax issues, laws, policies, and internal IRS functional processes that are the sources of taxpayer significant hardship and other critical problems.

59 TAS uses Criteria Code 5 for cases where the taxpayer has experienced a delay of 30 or more days to resolve a problem. TAS uses Criteria Code 6 for cases where the taxpayer has not received a response or resolution by a date promised.

60 Information extracted from the Business Performance Management System (BPMS), TAS Discretionary Report, Business Operating Division Report, Core Issue by Criteria Code on November 15, 2005. During FY 2004, TAS began reporting the EITC-RPS cases under additional Primary Issue Codes to capture more specific case issues.

61 IRC § 6212.

by the taxpayer's representative caused a lengthy delay in resolving the taxpayer's case.[62] The harm might be greater in cases where the taxpayer is unrepresented.

Another TAS case reveals further burdens placed on taxpayers and additional delays in the examination process. The IRS denied a taxpayer's EITC and EITC recertification for tax years 2001 through 2004. The IRS is working the cases for 2001 and 2002 at one campus and the 2003 and 2004 cases at a second campus, even though they all involve the same taxpayer and the same issue. This approach places an undue burden on the taxpayer, who is attempting to navigate the EITC exam process while having to deal with two different IRS offices.

W&I Compliance is aware of the problems taxpayers experience when their cases are worked at various campuses. W&I has indicated it will request an expansion of current programming that will allow for EITC recertification cases to be assigned to the same campus as the initial EITC exam.[63] Additionally, W&I has indicated a willingness to update the Internal Revenue Manual (IRM) to ensure that multiple year audits are assigned to the same IRS examiner to reduce taxpayer burden.[64] TAS commends W&I Compliance for these efforts.

Taxpayer Response Rate

Approximately 40 percent of EITC correspondence exams close as a "no response" or "undeliverable," indicating that the taxpayer did not respond to the IRS exam notice.[65] Acknowledging the problems associated with the high non-response rate, W&I Research conducted an EITC Pre-Refund Audit Non-Response Survey in March 2004.[66] The IRS surveyed employees and volunteer representatives that came in direct contact with EITC taxpayers when they sought assistance.[67] The survey responses suggest that most taxpayers categorized as non-responsive did attempt to make some form of contact with the IRS.[68] Of the taxpayers surveyed, 87 percent attempted to make some form of contact with the IRS, with 68 percent of taxpayers sending the requested documents via mail or fax. Only 13 percent of taxpayers surveyed indicated that they did not attempt to respond to the audit notice. Of the taxpayers who responded to the IRS notice, 68 percent mailed the requested documents and 67 percent sought assistance by calling the

[62] TAS received this information through the Systemic Advocacy Management System (SAMS). SAMS is a database of issues submitted to the TAS Office of Systemic Advocacy. It is designed to identify tax problems and monitor, analyze and resolve systemic issues submitted by TAS, IRS employees and external stakeholders.

[63] Information provided by Operating Division in response to research request.

[64] IRM § 4.19.1, *Campus Examination Operations* outlines W&I and SB/SE's campus examination procedures.

[65] AIMS Closed Case Database W&I and SB/SE.

[66] W&I Research Group 2, *EITC Pre-Refund Audit Non-Response Survey*, 2-03-12-2-021E (Mar. 2004).

[67] The individuals surveyed included IRS employees from TAS and Appeals, and Low Income Taxpayer Clinic (LITC) representatives. Taxpayers' themselves were not surveyed, rather the survey collected information about taxpayers' actions from taxpayer representatives.

[68] W&I Research Group 2, *EITC Pre-Refund Audit Non-Response Survey*, 2-03-12-2-021E 6 (Mar. 2004).

IRS or visiting an IRS office.[69] The survey results indicate a failure on the part of the IRS to handle taxpayers' attempts to engage in the audit process, thereby affecting a taxpayers' ability to prove their EITC claims.

While a high percentage of EITC correspondence exams close as "no response," an additional 16.7 percent of EITC correspondence exams close as "default with correspondence," indicating that the taxpayer attempted to engage in the audit process but ultimately left the system.[70] Taxpayers' reasons for dropping out of the exam process can be as simple as the fact that the taxpayer did not receive subsequent IRS correspondence regarding his or her audit. The 2004 certification study showed that approximately six percent of the letters the IRS sent to taxpayers in December 2003 were returned as undeliverable, even though the addresses were current as of the spring of 2003.[71] More importantly, almost half of the taxpayers selected for the follow-up telephone survey on the certification test could not be reached by mail or telephone. Of the taxpayers who were surveyed, approximately seven percent indicated that they lived in their current address for less than six months. The highly mobile nature of the EITC population suggests that one reason why some taxpayers do not respond to IRS correspondence is that they may never have received the correspondence in the first place.

More complicated reasons can also explain why so many taxpayers drop out of the system. A taxpayer may have a bad experience with the IRS and become discouraged with the exam process. Some taxpayers may realize that they were ineligible to receive the EITC and accept the result by not continuing to communicate with the IRS. Other taxpayers may be eligible to receive the EITC but realize they are unable to provide the required proof. Still other taxpayers may be suspicious of the government for various reasons and be reluctant to continue engaging with the IRS.

Given the myriad of reasons why taxpayers may engage with the IRS during the audit process and later drop out the system, we believe the IRS needs to better understand why taxpayers drop out in order to better serve these taxpayers. We recommend that the IRS conduct a study or survey of taxpayers to understand why some taxpayers do not follow through on the audit process. Moreover, we believe the IRS should develop a strategic goal to lessen the percentage of taxpayers in this category.

Problems with Documentation

Taxpayers who do respond to IRS exam correspondence and whose documentation is processed face still other hurdles in providing complete and accurate information. The two main problems are inconsistency as to which documents the IRS will accept (a

69 W&I Research Group 2, *EITC Pre-Refund Audit Non-Response Survey*, 2-03-12-21E6 (Mar. 2004). The percentages do not add up to 100 percent because respondents were allowed to choose more than one response.

70 AIMS Closed Case Database W&I and SB/SE.

71 IRS, *Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 23 (Oct. 2005). For background on the EITC certification study, *see supra* notes 5-9 and accompanying text.

document is accepted in one office, but not in another) and inflexibility in accepting proof (failure to accept other types of documents where the taxpayer cannot provide the standard documentation).[72]

Further, taxpayers are often unable to meet the IRS requirements for acceptable documentation, which do not take into account the realities of the type of documentation that low income taxpayers can provide.[73] While IRS requests for documentation are typically limited to bills and records, the IRS piloted the use of affidavits during the 2004 and 2005 certification studies. The 2004 certification study marked the first time IRS examination used affidavits for tax administration purposes.[74]

As part of the 2004 certification study, taxpayers were able to submit a completed affidavit to prove they met the qualifying child residency requirement. The majority of taxpayers in the test group of the certification study received a standard third party affidavit, Form 8836, *Qualifying Child Residency Statement (Schedule A)*, that could be completed by any of the following individuals: attorney, child-care provider, clergy, community-based organization, court or placement agency official, employer, health-care provider, Indian tribe official, landlord or property manager, law enforcement officer, school official, or social service agency or other government official.[75] Of the 25,000 taxpayers in the test group, the IRS also selected a subsample of 1,000 taxpayers to test a modified version of the affidavit.[76] The modified third party affidavit (Schedule B) could be completed by anyone who had personal knowledge or records showing that the taxpayer and qualifying child lived together during the tax year, except a spouse, dependent, qualifying child, or a parent of the qualifying child. These third parties include most relatives, friends, and neighbors. In testing the modified affidavit, the IRS was responding to concerns that taxpayers might have difficulty using the other approved sources and might easily prove that they meet the qualifying child residency requirement using the alternate affidavit.[77]

Within all taxpayers in the test group, 38 percent of all documents submitted were

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72 General Accounting Office, GAO-02-449, *Opportunities To Make Recertification Program Less Confusing and More Consistent* 21 (April 2002). Twenty-one examiners from four processing centers (campuses) were given five scenarios involving differing sets of supporting documents from EITC recertification cases and in no case did all examiners agree that the documents either supported or did not support the eligibility. In two of the five scenarios, the results varied significantly: Case A - 13 examiners accepted the documents and eight did not; Case D - seven examiners accepted the documents and 14 did not.

73 The problems with documentation are also discussed in TAS' recent EITC Audit Reconsideration study. *See* National Taxpayer Advocate 2004 Annual Report to Congress vol. II. Documentation difficulties or deficiencies with the original audit were the cause of audit reconsideration in 45 percent of the cases examined during the period of July 1, 2002 through January 31, 2003.

74 IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 8 (Oct. 2005).

75 *Id.* at 7.

76 *Id.* at 6.

77 *Id.* at 8.

records, 20 percent were official letters, and 42 percent were third party affidavits.[78] The overall acceptance rate of documents was 64 percent. The affidavits, however, had the highest acceptance rate of 82 percent, followed by letters with an acceptance rate of 55 percent, and records with an acceptance rate of 48 percent.[79] The acceptance rate of Schedule B affidavits was slightly lower than Schedule A affidavits, at 76 percent; however, this is still higher than the other methods of documentation provided.[80] The high acceptance rate of the Schedule B affidavits is encouraging because all Schedule B affidavits underwent a mandatory verification process, including contacting the affiant to validate the affidavit.[81] The 2004 certification study results conclude that, "[i]n general, the affidavits seemed to provide a reliable way to substantiate claims in this context."[82]

The problems associated with documentation were discussed at a recent IRS Nationwide Tax Forum[83] and a participant cited the following experience she had with a client:

> A single father with one child in college received a letter from IRS notifying him the IRS changed his tax return filing status to single with no dependent, and now he owes $1,700. In trying to resolve this, the tax professional and the taxpayer were overwhelmed by request[s] for proof of claims and contradictory request[s] for information. The IRS eventually allowed the credit but the tax professional felt the IRS treated the client as a criminal rather than as a taxpayer, as though the taxpayer is guilty. Further, the tax professional felt the IRS employee in this case acted as though they were doing the taxpayer a favor by finding that he was entitled to the EITC.

Also during this forum, the following question was posed to the participants: "Does your client understand what is expected of them when the IRS requests documentation?" All nine participants answered, "No".[84]

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[78] IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 28 (Oct. 2005).

[79] For a document to be accepted, it must have been completed, in its entirety. Only ten percent affidavits underwent mandatory validation. These statistics do not reflect the validity of the information provided in the documents. For a document to be accepted it had to include all required information (name, address, dates of residence), statements or letters had to be on official letterhead, Third Party Affidavits had to be filled out completely and signed, all information had to be legible, and the document had to be from an allowable source. For documentation subject to mandatory validation (selected documents for 10 percent of Schedule A subgroup cases and all of Schedule B subgroup cases) the validity of the document itself was verified.

[80] IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress, October 2005* 33 (Oct. 2005).

[81] *Id.*

[82] *Id.*

[83] IRS Nationwide Tax Forum 2005, TAS Focus Group, EITC Exams and Documentation Requirements, San Francisco, California (June 29, 2005).

[84] IRS Nationwide Tax Forum 2005, TAS Focus Group, EITC Exams and Documentation Requirements, San Francisco, California (June 29, 2005).

EITC Recertification

In 1997, Congress enacted legislation to help prevent taxpayers from incorrectly receiving the EITC, and in 1998 the IRS implemented the EITC recertification process.[85] The EITC recertification process places a recertification indicator on the account of a taxpayer whose EITC claim was audited and denied completely or in part. The indicator prevents the payment of future EITC claims until the taxpayer successfully completes the recertification process and demonstrates his or her eligibility to receive the EITC.[86] Once the taxpayer meets the requirements necessary to prove eligibility, the taxpayer is "recertified" and the IRS should remove the recertification indicator from the taxpayer's account.

Generally, there are two ways to begin the EITC recertification process. Taxpayers can request audit reconsideration, asking the IRS to reevaluate the prior exam that resulted in the IRS denying the EITC and placing a recertification indicator on the taxpayer's account.[87] More commonly, a taxpayer can file Form 8862, *Information to Claim Earned Income Credit After Disallowance*, which alerts the IRS to begin the recertification process.[88] The recertification process generally takes the form of an examination of a taxpayer's EITC claim, very similar to an EITC correspondence examination. Once the taxpayer meets the eligibility requirements, he or she is considered "recertified" and the IRS should remove the recertification indicator. If the IRS determines that the taxpayer's original EITC error was due to reckless or intentional disregard of rules and regulations, the taxpayer cannot receive the EITC for two years.[89] If the IRS determines the original EITC error was due to fraud, the taxpayer cannot receive the EITC for ten years.[90]

Although the recertification process was designed to prevent incorrect EITC payments, the process has resulted in numerous problems for taxpayers. Both the Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA) recently audited the recertification program and noted the process is inconsistent and confusing to taxpayers.[91] The IRS has taken steps to correct some of the

[85] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

[86] IRM § 21.6.3.4.2.7.15.1 Once EITC is disallowed through statutory procedures, the taxpayer must file Form 8862 with the next tax return on which the taxpayer claims EITC. Examination reviews all returns with Form 8862 to determine if EITC is allowable (once the taxpayer meets evidentiary requirements, they are "recertified" and the IRS should remove the recertification indicator). For years after 2001, if the taxpayer is claiming the EITC without a qualifying child, a Form 8862 is not required.

[87] IRM § 4.13.1.2, *Definition of an Audit Reconsideration* (Feb. 1, 2003).

[88] A taxpayer should file Form 8862 with the next tax return on which they claim the EITC with qualifying children.

[89] IRC § 32(k)(1)(B)(ii).

[90] IRC § 32(k)(1)(B)(i).

[91] Treasury Inspector General for Tax Administration, Ref. No. 2005-40-039, *The Earned Income Credit Recertification Program Continues to Experience Problems* (Mar. 2005); Treasury Inspector General for Tax Administration, Ref. No. 2005-40-015, *Application of the Earned Income Credit Two-year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers* (Dec. 2004); General Accounting Office, GAO-02-449, *Earned Income Credit Opportunities To Make Recertification Program Less Confusing and More Consistent* (Apr. 2002).

problems taxpayers encounter during recertification, including revising letters, simplifying Form 8862, *Information to Claim Earned Income Credit After Disallowance*, incorporating guidelines in the Internal Revenue Manual (IRM), and including additional information on the two and ten year recertification bans in Publication 596, *Earned Income Credit*. While the IRS has made progress, taxpayers continue to experience numerous problems with the EITC recertification process.

EITC Recertification Statistics

The EITC recertification program began in 1998, when the IRS disallowed, in whole or in part, EITC claims for approximately 312,000 tax year 1997 returns and placed recertification indicators on those taxpayers' accounts.[92] The size of the recertification program continues to grow and by December 2004, the IRS placed over 1.2 million recertification indicators on taxpayer accounts.[93]

Once the IRS places a recertification indicator on a taxpayer's account, the process of recertifying is difficult and lengthy. A taxpayer must undergo an examination of his or her EITC eligibility, which results in the same delays and documentation problems taxpayers face in standard EITC examinations, as well as additional problems associated with recertification. One result is that the IRS does not release many recertification indicators timely, affecting taxpayers future ability to receive the EITC.

A recent TIGTA report notes that as of April 2003, 52,000 taxpayers did not have recertification indicators removed from their accounts, even though the IRS allowed subsequent EITC claims. By March 2004, 17,000 of the 52,000 taxpayers still had the recertification indicator on their account, even though a year had passed.[94] The delays experienced in getting the recertification indicator lifted from the 52,000 taxpayers resulted in 10,500 taxpayers having almost $21 million in future EITC claims improperly denied, while 17,000 taxpayers had their EITC claims unnecessarily examined.[95]

Delays in Recertification Process

Once the IRS places a recertification indicator on a taxpayer's account, the taxpayer must undergo a lengthy recertification process. Even in cases where the taxpayer is not subject to a two or ten-year ban, the time necessary to recertify can prevent the taxpayer from receiving their EITC claim for a significant period of time. Table 1.5.4 demonstrates the cycle time for different types of EITC recertification cases in fiscal years 2004 and 2005.

[92] General Accounting Office, GAO-02-449, *Earned Income Credit Opportunities To Make Recertification Program Less Confusing and More Consistent* 5 (Apr. 2002).

[93] Treasury Inspector General for Tax Administration, Ref. No. 2005-40-039, *The Earned Income Credit Recertification Program Continues to Experience Problems* 36 (Mar. 2005).

[94] *Id.* at 6.

[95] *Id.*

TABLE 1.5.4, WEIGHTED CYCLE TIME FOR EITC RECERTIFICATION CASES FOR FISCAL YEARS 2004 AND 2005

Type of EITC Recertification Case	Fiscal Year 2004[96]	Fiscal Year 2005[97]
EITC Recertification – 1040X, Amended Return[98]	155.3 days	115.6 days
EITC Recertification	185.6 days	171.3 days
EITC Recertification – 2 year ban	113.4 days	138.2 days
EITC Recertification – 10 year ban	112.9 days	163.0 days

As shown above, the IRS made significant progress in the past year in reducing the cycle time of general recertification and 1040X recertification cases. On the other hand, the cycle time for two- and ten-year ban cases increased from 2004 to 2005.

Although the reasons for the lengthy cycle time are unclear, the effects of delay can be great. During calendar year 2003, TIGTA identified over 3,200 taxpayer accounts with EITC refunds totaling over $3.9 million that were not timely released, with delays averaging over one year. After TIGTA referred the problem to the IRS, additional delays of one year or more preceded the release of approximately 1,000 of the 3,200 refunds.[99] Additionally, TIGTA noted that during 2003, the IRS sent taxpayers approximately 850,000 letters or electronic messages that did not clearly or accurately communicate EITC recertification requirements, did not specifically inform taxpayers that they were recertified, or referred to an enclosed recertification form that was not in fact enclosed. The unclear communication made it harder for taxpayers to understand and comply with recertification requirements and may have resulted in delays in the recertification process.[100]

Inconsistent Treatment of Recertification Cases

Some of the problems associated with the recertification process stem from IRS' inconsistent application of the rules and requirements for recertification. One of the most notable cases of inconsistent treatment comes from IRS imposition of the two-year ban. The IRS generally does not place a ban on an account during the first year of an EITC examination unless the taxpayer has demonstrated blatant disregard for the rules and regulations surrounding the EITC.[101] Where the IRS previously informed the taxpayer about EITC rules and the taxpayer provides inadequate documentation that results in

96 AIMS Closed Database (not limited to correspondence audits). The weighted average cycle time for all EITC recertification cases in FY 2004 was 183.8 days.

97 AIMS Closed Database – FY 2005 Data Extract Cycle 20056 (not limited to correspondence audits) The weighted average cycle time for all EITC recertification cases in FY 2005 was 168.1 days.

98 These are cases in which the taxpayer did not originally claim the EITC on his or her return, but filed a 1040X, Amended Return claiming the EITC and the taxpayer has a recertification indicator on their account.

99 Treasury Inspector General for Tax Administration, Ref. No. 2005-40-039, *The Earned Income Credit Recertification Program Continues to Experience Problems* 13 (Mar. 2005).

100 *Id.* at 3.

101 IRM § 4.19.1.5.4.1 EITC 2/10 Year Ban, Table 1, Example 1.

another EITC disallowance, the IRS will place a two-year ban on the taxpayer's account in the year of the subsequent EITC disallowance.[102]

A recent TIGTA audit found significant differences in the criteria used to apply the ban at different IRS compliance sites and among different examiners. The audit found that examiners used inconsistent criteria, and applied some bans incorrectly and others unintentionally, with the result that taxpayers were not treated consistently.[103] This confusion and inconsistent treatment was due in part to the fact that IRS guidelines for bans were not clear, complete, or consistent, and did not always reflect current law.[104]

Problems with Documentation

The biggest problem with EITC recertification cases, as with most EITC examinations, is a taxpayer's ability to provide the IRS with adequate documentation to substantiate EITC eligibility. According to a recent TIGTA audit, some of the cases where a taxpayer submits insufficient documentation result in the IRS imposing a two-year ban because the taxpayer was unable to provide sufficient documentation in the subsequent examination of their EITC claim. Given the documentation difficulties associated with the EITC, TIGTA stated that imposing a two-year ban where there is a lack of documentation is inappropriate. TIGTA indicated the IRS should only impose a two-year ban where the taxpayer clearly did not meet the legal requirements for claiming the EITC and the taxpayer was made aware of the legal requirements.[105]

A GAO report echoes the documentation difficulties experienced in the recertification processing, noting that low income taxpayers often have difficulty obtaining documents that IRS examiners will accept and, when they do submit documentation, IRS examiners' assessment of the documents is inconsistent.[106] GAO noted that the toughest EITC eligibility requirement for taxpayers to meet is the qualifying child residency requirement. Of the IRS examiners GAO questioned regarding the recertification process, 80 percent said that when a taxpayer fails the recertification process, most or all of the time the taxpayer's inability to substantiate that the child lived with them led to the failure to

102 IRM § 4.19.1.5.4.1 EITC 2/10 Year Ban, Table 1, Example 2.

103 Treasury Inspector General for Tax Administration, Ref. No. 2005-40-015, *Application of the Earned Income Credit Two Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers* (Dec. 2004).

104 *Id.* An example provided on page 5 reads as follows: "Some examiners routinely applied the ban in the subsequent examination when, in our opinion, there was no clear indication of "reckless or intentional disregard" of EIC rules". IRS Management agreed with the TIGTA findings and have revised sections of the IRM regarding the two-year ban and updated the Service Center Exam Continuing Professional Education for 2005 to incorporate more examples. Page 30.

105 Treasury Inspector General for Tax Administration, Ref. No. 2005-40-015, *Application of the Earned Income Credit Two Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers*, Ref. No. 2005-40-015 (Dec. 2004).

106 General Accounting Office, GAO-02-449, *Earned Income Credit Opportunities To Make Recertification Program Less Confusing and More Consistent* (Apr. 2002).

recertify.[107] The failure to provide adequate supporting documentation is due in part to the tendency of many low income taxpayers to move frequently, have no medical insurance, and use informal child care arrangements. These characteristics of low income taxpayers prevent them from being able to provide formal documentation to substantiate their EITC claim.[108]

In addition to presenting time and documentation difficulties, the current EITC recertification process makes no allowance for taxpayers who are subject to a two-year ban, but whose returns show legitimate changes that would make them eligible to receive the EITC. EITC taxpayers' situations are subject to change (*e.g.*, the taxpayer remarries and has children who were not included on the return originally audited, custody arrangements change, dependents move into the taxpayer's household for more than six months of the year) while the two-year ban is in effect. The current statute does not allow for a reevaluation of a taxpayer's EITC eligibility prior to the expiration of the two-year ban.

Approaches to Improving the EITC Exam Function

As discussed above, the current EITC examination structure creates significant problems for taxpayers required to navigate this complicated process. One component of the IRS's five-point initiative is to minimize burden and enhance the quality of communications with taxpayers by improving the audit process.[109] The importance of the audit process cannot be undervalued, as the way in which the IRS conducts audits can have a dramatic effect on the audit outcome, as demonstrated by the recent EITC Audit Reconsideration Study.[110] As part of the EITC Audit Reconsideration study results, the National Taxpayer Advocate set forth a number of recommendations to improve the EITC audit and audit reconsideration process. Those recommendations, and others, should begin a discussion about ways to improve the current EITC examination process, including EITC recertification.

Improved Communication

One of the biggest problems in the current EITC exam process is the need for improved communication with EITC taxpayers, particularly during the initial audit. Of the cases reviewed for the EITC Audit Reconsideration Study, nearly 80 percent of the audit reconsideration requests resulted from difficulties with documentation, non-response or late response from the taxpayer. Improved communication could help resolve many of these problems and significantly reduce the number of costly and burdensome examinations, recertifications, and audit reconsiderations.

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107 General Accounting Office, GAO-02-449, *Earned Income Credit Opportunities To Make Recertification Program Less Confusing and More Consistent* 14 (Apr. 2002).

108 *Id.* at 19.

109 IRS, *IRS Announces Steps to Improve EITC Administration, Seeks Public Comment*, IR-2003-78 (June 13, 2003).

110 National Taxpayer Advocate 2004 Annual Report to Congress vol. 2.

Some communication improvements can come from increased use of the telephone, which allows taxpayers to better understand what supporting documentation is needed to substantiate their claims and affords the IRS an opportunity to educate the taxpayer. The opportunity for interaction is especially important for low income, Limited English Proficient (LEP) and underrepresented taxpayers, who make up a large part of the EITC population. IRS exam units currently have a toll-free number with individual extensions for each examiner, but the examiners rarely utilize this opportunity for phone contact with the taxpayer. In January 2006, the W&I exam function will begin using a single toll-free telephone number that will route taxpayers to an available examination employee and will also have an option to key in an individual extension number.[111] We commend W&I exam for making it easier for taxpayers to communicate with the IRS and hope examination employees will be encouraged to call taxpayers for information and provide the toll-free phone number for taxpayers' responses.

This is not to say that IRS examiners should call taxpayers in every examination. The IRS should train its examiners to identify instances in which calling the taxpayer will help clarify an issue or obtain a response from a taxpayer. This type of targeted communication with taxpayers will ultimately save time and money down the line. During these communications, IRS employees can also work with the taxpayer to help explain the type of documentation that the IRS needs to resolve his or her case.

Expand Acceptable Documentation

The current exam process has raised questions about the ability of low income taxpayers to provide sufficient documentation to substantiate an EITC claim. The 2004 certification study piloted the use of an affidavit as a method of proving the qualified child residency requirement for the EITC. The study results indicate that the affidavit was the most effective means of proving eligibility; taxpayers preferred using the affidavit to providing documents, records, or letters.[112]

Given the effectiveness of the affidavit, and taxpayers' willingness to use the new form, we believe use of the affidavit should be expanded to all correspondence examinations, as well as the recertification process. Allowing all taxpayers subject to a correspondence exam or attempting to recertify to submit affidavits to substantiate their EITC claims can help resolve exams early on and may encourage increased participation by taxpayers if they know they are capable of sending the IRS the requested information. Additionally, in light of recent natural disasters, the IRS is grappling with the issue of how to handle taxpayers who will not be able to provide documentation to verify claims. In these circumstances, the affidavit can provide an effective alternative means of verifying taxpayers' information, preferably the Schedule B affidavit, which allows neighbors and family members to certify that a child lived with the taxpayer.

111 Information provided by operating division.

112 For a complete discussion of the use of the affidavit during the 2004 certification study, *see supra* notes 74-82 and accompanying text.

Case Assignments

The problems with the EITC exam process also raise the need for a specialized examination group dedicated to EITC as part of the larger EITC Program Office. A specialized exam group can help to enhance taxpayer service and reduce audit time for EITC taxpayers. The IRS closes a large number of EITC exam cases due to a late response or no response by the taxpayer. The lack of response or late response may be closely tied to the IRS' use of batch processing, with very limited involvement by a tax examiner.

With an exam case handled through batch processing, when a taxpayer contacts the IRS regarding his or her case, the taxpayer does not have an assigned tax examiner with whom he or she can communicate. This causes frustration for taxpayers who must repeat their stories to a different IRS employee every time they call. This frustration can eventually cause taxpayers to drop out of the audit process and stop trying to reply to IRS requests. We believe a better approach is for the IRS to assign EITC exam cases to specific exam employees early in the process to ensure that taxpayers have an assigned caseworker with whom they can communicate. The IRS is moving towards a caseworker approach by creating the toll-free phone number taxpayers can use to reach an examination employee to discuss their case.

The caseworker approach is one reason why the Taxpayer Advocate Service (TAS) is so effective in working with taxpayers. When a taxpayer comes to TAS for assistance, TAS assigns one caseworker to the taxpayer's case. This allows the taxpayer to develop a relationship with the caseworker and may encourage the taxpayer to respond to calls and requests for information. The taxpayer is not shuttled from person to person and they can be confident that their information is not getting lost. A similar approach could benefit EITC examinations and may help resolve exams earlier in the process.

Training on Working With EITC Taxpayers

To ensure consistent application of EITC law and acceptance of documentation, we believe EITC examiners should receive updated, specialized training, including information on how to deal effectively with low income and low literacy taxpayers. The Taxpayer Advocate Service (TAS) provided this type of training to the IRS employees in Kansas City who handle the EITC Precertification Program. This training, tailored to dealing with the EITC population, was very well received. The Taxpayer Advocate Service is working to expand this training and make it available to a wide range of IRS employees.

IRS COMMENTS

The National Taxpayer Advocate's discussion of Earned Income Tax Credit (EITC) examination issues highlights some of the challenges the IRS faces in administering one of the nation's largest anti-poverty programs through the tax code. In fact, the IRS has been steadily working to address the problems the National Taxpayer Advocate identifies. In some cases, we already implemented solutions. In others, we are working on alternatives. In a few instances, we believe the National Taxpayer Advocate's proposed solutions may warrant additional analysis.

Overall, however, we appreciate the National Taxpayer Advocate's acknowledgement of the progress that the IRS made to administer a balanced EITC program, one that encourages participation while reducing EITC paid in error. We also agree that there is still room for improvement. For tax year (TY) 2003, more than 21 million taxpayers filed EITC returns with over 26.8 million qualifying children. The $38 billion in EITC that taxpayers received makes the credit program one of the largest anti-poverty programs in the country.

The IRS has a robust strategy to address the challenges in the EITC program. Among other things, we developed numerous business process enhancements – including some that rely on private sector best practices – aimed at improving both the way in which we examine EITC returns and the effectiveness of our communications with EITC taxpayers. In particular, these enhancements enable us to use data-driven scoring and selection methods to better identify egregious cases for examination and to then apply the most effective and efficient compliance treatments.

We are also working with the National Taxpayer Advocate to explore the use of new notices to improve the rate of taxpayer response as well as to enhance the overall quality of our communications with taxpayers. We developed a comprehensive research strategy to increase our understanding of the EITC taxpayer so we can better focus our educational and compliance activities. We will continue the final phase of testing in fiscal year (FY) 2006 to evaluate the effect of a residency certification requirement on claim accuracy, participation, and burden. Our communication outreach plan includes a strategy to develop a bilingual integrated marketing campaign and a special focus on victims of hurricanes Katrina and Rita.

EITC Examination Cycle Time

We appreciate the National Taxpayer Advocate's recognition of our work to improve EITC cycle time. Over the past several years, the IRS made significant improvements in our EITC examination process. For example, we reduced the average time it takes to complete an exam (cycle time) by 20 days – despite the implementation of a new letter process adopted at the request of the National Taxpayer Advocate which added 36 days. We continue to look for ways to achieve further improvements in EITC cycle time and will include the NTA in our process.

EITC Audit Rates

The National Taxpayer Advocate correctly notes that EITC examinations make up a significant portion of the audits the IRS performs each year and that EITC taxpayers face a higher chance of audit than most taxpayers do. It is important to place these figures in context. First, EITC erroneous payments were the subject of significant Congressional attention – including a mandate of and funding for a special, five-year compliance initiative aimed at combating EITC error.

More recently, with the adoption of the Improper Payments Improvement Act (IPIA), erroneous EITC payments are under additional statutory scrutiny. The Act requires the IRS to estimate EITC error annually and take measurable steps to reduce it. The EITC examination approach is part of the IRS' plan to comply with IPIA – as are our numerous outreach and education activities. EITC is the only IRS program currently covered by the IPIA.

EITC Recertification Program

In her discussion, the National Taxpayer Advocate refers to a number of problems with the EITC Recertification program – problems discussed in TIGTA and GAO reports dating from the end of TY2003. Since the issuance of these reports, the IRS made a variety of improvements to the process.

We believe the EITC Recertification Program is an essential enforcement tool that promotes compliance, protects revenue, and reduces erroneous payments. Here is an overview of actions we took to address weaknesses in the Recertification Program:

- In January 2004, we implemented programming that would automatically release the EITC Recertification Indicator on most closed examinations, and audit reconsiderations. This has significantly reduced the number of EITC Recertification indicators not properly removed.
- Effective January 2004, we began immediately refunding the portion of taxpayers' refunds that are not in question and automatically releasing the EITC portion for which taxpayers are eligible upon closure of the audit. This drastically reduced the number of "delayed" refunds when the audit is closed.
- For the few situations not addressed by the programming enhancements detailed above, we adjusted our problem correction reports to make them more convenient and exact. These reports will help us identify any accounts needing the EITC Recertification indicators removed or refunds released. Adjustments to these reports were available in March 2005.
- We incorporated informal recertification guidelines into the Internal Revenue Manual (IRM), and successfully delivered a Continual Professional Education (CPE) lesson on EITC Recertification to all tax examiners in 2004.
- Working with the National Taxpayer Advocate's staff, we improved Form 8862, *Information to Claim Earned Income Credit after Disallowance* in 2005 to reduce taxpayer burden. Our improvements reduced the estimated amount of time taxpayers need to comprehend and complete the form by 68 minutes or 49 percent less time.
- Starting in 2005 for EITC Recertification and all EITC programs, we now send two separate notices (CP 75 series and Letter 525) to taxpayers rather then one initial

contact letter requesting supporting documentation for EITC. We also redesigned the notices to make them clearer. This provides taxpayers with more opportunities to reply to our information requests.

- During 2006, we plan further improvement to CP 79 (mailed to taxpayers when Examination denies EITC) and other EITC notices to improve communications regarding the EITC Recertification and documentation requirements to taxpayers.

Audit Reconsideration is the process the IRS uses to reevaluate the results of a prior audit when the taxpayer disagrees with the audit determination and they possess documentation not previously considered. We shared the National Taxpayer Advocate's concern regarding Audit Reconsiderations and therefore instituted the following changes.

- We developed special Audit Reconsideration Reports that will allow us to track the results of the reconsideration process. They show the total reconsideration requests we handle each year, the type of case worked (EITC, Discretionary and Proof of Concept), the results of the reconsiderations (full/partial reversal, full/partial disallowance), and the monetary value of the abatements.
- Beginning in February 2005, we established a process that enabled us to review all case files (Audit Workpapers, Reports, Statutory Notice of Deficiency, and Letters issued), monitor the population of the Audit Reconsideration Reports, and automatically track all actions taken with regard to each reconsideration case.
- A special Audit Reconsideration Task force reviewed the Audit Reconsideration Manual (IRM) 4.13, and related materials used in the process (Publication 3598, *What You Should Know About the Audit Reconsideration Process*, Letters, Training Manuals). Task Force members included Wage and Investment (W&I) and Small Business/Self-Employed Reporting Compliance and Taxpayer Advocate Service (TAS). As a result of the Task Force's work, we completely revised the IRM § 4.13, updated the Publication 3598, reviewed letters used in the program, revised our training materials, and established an Audit Reconsideration website that can be accessed by the taxpayer.

The National Taxpayer Advocate's report makes four recommendations to improve the EITC Exam Function. These are our responses to these items.

Improved Communications

We realize the importance of improving our communications with the EITC taxpayers. In FY 2005, we completed several studies that showed extension-routed calls went directly to voice-mail, thus creating frustration for the taxpayers. This also created frustration for our examiners when they attempted to return the calls. In response, we tested the feasibility of expanding the coverage on these types of calls with positive results.

We realize that live contact with the taxpayer not only improves customer satisfaction, it also improves the examination process by educating the taxpayer on what they need to do. We now encourage examiners to attempt contact with taxpayers by telephone to explain fully what they need to complete the examination before sending a letter. To underscore our commitment to this approach, we will now hold senior IRS officials responsible for improving coverage on extension routed calls. In 2006, we will roll out Intelligent Call Management (ICM), which will enable us to provide better service to our taxpayers by routing calls received in the toll-free phone operations through an enterprise queue, then directing the calls to an assistor at one of our sites based on availability. In addition, bi-lingual taxpayers will receive better service because we will direct calls from our Spanish-speaking taxpayers to campuses with bi-lingual examiners. ICM provides better management control of telephone traffic, staffing by time zones, and demand.

Expand Acceptable Documentation

We recognize obtaining documentation can put a burden on taxpayers. That is why taxpayer burden is one of the factors we consider when we evaluate potential new approaches to reducing EITC error. It is also, why, as part of the test of a residency certification requirement, we tested affidavits as a form of proof. As the National Taxpayer Advocate notes, we found affidavits to be a reliable and effective means of documentation. However, we believe it is premature to conclude affidavits should become a regular part of the EITC examination process. While affidavits do appear to offer significant promise as a way to reduce taxpayer burden, our testing did not replicate the "real world" conditions of many EITC taxpayers.

In fact, the test was conducted on 25,000 taxpayers who were randomly distributed across the United States. Thus, the awareness of affidavits was very limited as was the potential for "gaming" these documents. The real question is whether a broader understanding and awareness of affidavits through the EITC population would encourage non-compliant taxpayers to use affidavits as a means of erroneously claiming the credit. Because of this potential for abuse, we need further testing of affidavits in a variety of different scenarios before we adopt affidavits on the scale recommended by the National Taxpayer Advocate.

We also believe that we can address some of the National Taxpayer Advocate's concern by improving our business processes to ensure consistency across our examiners. To this end, we developed an integrated decision support tool that guides our employees through each EITC examination and focuses their work on the specific audit issue for which each return was selected. Thus, no matter where taxpayers are located, similar situations will receive similar treatment.

At the same time, we want to tap into the collective expertise of our examiners. That is why our Correspondence Examination Procedural training emphasizes the importance of examiners using their judgment in evaluating taxpayer replies and analyzing their cases. Using judgment in all examinations is an established policy that we reinforce at every opportunity. In our training material, examples and exercises explain the different documentation scenarios an examiner may come across when working a case. We encourage the instructors to use "real-life" case situations to make the training as accurate and real as possible.

We also reinforce the use of judgment by examiners as an integral part of the 80/20 concept. We trained all examination employees in the use of this concept. We visited each of the campuses and reviewed cases to determine its usage, and gave spot awards to employees who used it. We also visited each of the campuses in FY 2005, held focus groups to determine where we were at and what we needed to do to take this concept to the next level.

Case Assignments

The National Taxpayer Advocate recommends early assignment of cases to a specific examiner and acknowledges the difficulty in doing so in a batch processing system. We realize the need to provide taxpayers specialized services and the benefits of keeping taxpayers in the audit process. In FY 2005, we enabled our telephone assistors to receive a universal "view" of any taxpayer case so they could identify specific items needed to resolve the case and provide this information to the taxpayer. We are now working on a further enhancement that will allow universal "access" so any employee receiving a call can actually take control of the case and perform the necessary actions to resolve the case. This approach is consistent with private sector best practices and, we believe, will be even more effective than limiting service to taxpayers to an assigned caseworker.

Training on Working with EITC Taxpayers

We are pleased the National Taxpayer Advocate found that training for dealing with the EITC population was very well received by the employees in Kansas City who work in the Precertification Test Program. We welcome the opportunity to partner with TAS in delivering this training for Examination employees in the future.

Another recent partnering effort was *"Getting to Know You,"* the W&I Compliance/TAS joint collaboration held in September 2005. The theme, *"Getting to Know You,"* reflected the partnering of both organizations by sharing improvement initiatives implemented in FY 2005, reviewing strategies planned for FY 2006 and preparing best practices. Participants included representatives from all W&I Compliance campuses and functions as well as representatives from TAS Headquarters and all seven TAS Area offices.

We worked closely with the National Taxpayer Advocate's office on many issues that affect EITC taxpayers and believe this collaboration resulted in many improvements to the process.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate acknowledges the challenges the IRS faces in administering the Earned Income Tax Credit (EITC) and is very pleased with the improvements the IRS has made in recent years. The IRS's response above demonstrates that it has developed a strategy to address current challenges in the EITC program, including business process enhancements, notice improvements, a comprehensive research strategy, improved communication outreach plan, and continued study of a possible certification requirement. Moreover, the IRS has taken significant steps to address weaknesses in the EITC Recertification Program, using analysis and technology to improve service to low income taxpayers. We are especially pleased with the improvements to the examination and audit reconsideration process. In particular, encouraging examiners to attempt telephone contact with taxpayers and holding senior IRS officials responsible for improving coverage on extension routed calls model exam practices and strike the proper balance between taxpayer rights and efficiency. We applaud these efforts, along with the use of ICM and improved bilingual call routing, and look forward to continuing to work with the IRS to ensure ongoing improvements in the EITC program.

While we acknowledge that erroneous EITC payments continue to be subject to significant Congressional and OMB scrutiny, the National Taxpayer Advocate remains concerned that as a result, EITC taxpayers have a much higher audit rate than other groups of taxpayers. Although the National Taxpayer Advocate is mindful of the problems associated with improper payment of the EITC, the IRS should consider that, given the complexity of the EITC, auditing low income taxpayers may not be the most effective way to reduce erroneous payments.

Expand Acceptable Documentation

The IRS recognizes the burden EITC taxpayers experience in trying to provide the IRS with acceptable documentation to support an EITC claim. The IRS has also recognized that thus far, affidavits have been a reliable and effective means of providing documentation. While we support additional testing of the affidavit concept, we are concerned by the IRS's comments that a broader use of affidavits might provide non-compliant taxpayers with the means to erroneously claim the EITC. The proven benefit to taxpayers from affidavits should not be overshadowed by potential abuses. Thus, we encourage the IRS to consider expanding the use of affidavits to all EITC examinations, particularly in light of the documentation difficulties faced by taxpayers affected by the recent disasters.

Case Assignments

We applaud the IRS's move to provide telephone assistors a "universal view" of any taxpayer case so that any assistor can answer a taxpayer's question. The IRS is working on a universal "access" system that will allow any employee to not only view a taxpayer's case, but work it to resolution as well. Universal access should be helpful in resolving EITC exam cases, particularly in situations where there are recertification, audit reconsideration, and EITC exams of the same taxpayer. We encourage the IRS to use "universal access" technology to allow an IRS examiner to look at all of these actions together and take the necessary steps to resolve all of the taxpayer's outstanding EITC issues as one case. This approach minimizes taxpayer burden, eliminates delays, and reduces redundant IRS actions.

Training on Working with EITC Taxpayers

The National Taxpayer Advocate is pleased that TAS and Wage and Investment Compliance have collaborated on several occasions in providing training to W&I employees. The National Taxpayer Advocate looks forward to continuing these joint efforts.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

- Continue developing correspondence (including letters, publications, and document requests) that will lessen taxpayer confusion and generate a greater response from taxpayers during the examination process.
- Ensure that procedures are in place so that taxpayer correspondence is timely processed and acknowledged.
- Continue to develop research initiatives and recommendations to improve the administration of the EITC program, including the TAS study to evaluate the impact of representation on the outcome of EITC audits and the study to identify the most significant barriers taxpayers encounter during EITC audits.
- Ensure that all employees receive clear guidance and training on the application of the two and ten year EITC recertification bans.
- Continue developing new processes (such as the use of alternative methods of documentation, the decision support tool, and encouraging examiners to use judgment) that will ease the burden taxpayers encounter when trying to provide the IRS with the requested documentation during the exam process.
- Continue to train EITC examination employees, utilizing real case examples (including TAS cases), on the importance of using judgment when deciding whether to allow or deny an EITC claim.
- Use "universal access" in EITC cases to enable any Exam employee to access a taxpayer's case and take the steps necessary to resolve the case, including consolidating all EITC issues pertaining to that taxpayer – examination, audit reconsideration, and recertification – under one employee.

PROBLEM

TOPIC #6 MOST SERIOUS PROBLEM: LEVIES ON SOCIAL SECURITY PAYMENTS

RESPONSIBLE OFFICIALS

Richard J. Morgante, Commissioner, Wage & Investment Division

Kevin M. Brown, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

Under the Federal Payment Levy Program (FPLP), the IRS may issue continuous levies up to 15 percent of a taxpayer's federal disbursements. FPLP levies on Social Security benefits may cause economic hardship to low income and other at-risk taxpayers, especially since the IRS has no effective mechanism for excluding low income taxpayers from this continuous levy. The IRS continues to process FPLP levies without managerial approval, causing undue burden on Social Security recipients.

When the IRS places manual (non-FPLP) levy on a taxpayer's Social Security benefits, the 15 percent limitation does not apply. Despite guidance to the contrary, the IRS sometimes subjects taxpayers to both FPLP and manual levies simultaneously.

ANALYSIS OF PROBLEM

Background

The Social Security Administration (SSA) provides benefits to 48 million individuals annually, paying out $493 billion in 2004.[1] The SSA provides two general categories of benefits – Supplemental Security Income (SSI) and Old-Age, Survivors, and Disability Insurance (OASDI). The SSI program provides needs-based (means-tested) benefits to individuals who are age 65 or older, blind, or disabled. The OASDI program protects against the loss of earnings due to retirement, death, or disability.

When a recipient of an OASDI Social Security payment incurs a federal tax debt, the IRS may place a levy[2] on that payment via a continuous levy[3] under the FPLP or a manual levy on a specific payment, but not both.[4] Continuous FPLP levies are limited to 15 percent of the federal payment, but there is no such restriction on how much the

[1] Social Security Administration, *2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 2005), available at http://www.ssa.gov/OACT/TR/TR05/trTOC.html.

[2] A levy is a legal seizure of property to satisfy a tax debt. IRC § 6331 provides the IRS with the general authority to levy funds held by a third party (such as an employer).

[3] A continuous levy remains in effect from the date it is first made until the levy is released. IRC § 6331(h)(1).

[4] *See* IRM § 5.19.9.3.3 (Rev. 7-14-2005). If an FPLP levy is already in place, the IRS can issue a manual levy on other levy sources, but not the same FPLP levy source.

IRS can levy manually.[5]

Federal Payment Levy Program

In the Taxpayer Relief Act of 1997 (TRA 97), Congress authorized the IRS to issue continuous levies up to 15 percent of a taxpayer's federal disbursements using a paperless process.[6] The FPLP is an automated levy program that systemically matches IRS records against the records of the Financial Management Service (FMS)[7] to locate federal payment recipients who have delinquent income tax debts.

When a match occurs, the IRS attempts to notify the recipient of the potential levy by sending a letter with information about the tax liability and the taxpayer's appeal rights.[8] As an additional precaution for levies involving a benefit paid by the SSA, the IRS sends a second notice (CP 91 or CP 298, Final Notice Before Levy on Social Security Benefits) before transmitting the levy to the FMS.[9] When FMS levies a payment, it sends a notice to the taxpayer's address of record on file with the appropriate federal agency.[10]

Taxpayer Notification

The National Taxpayer Advocate is concerned that taxpayers may not receive ample notice prior to levy. The IRS policy is to send FPLP notices to the last known address on the master file. However, because many Social Security recipients are retired and have not had tax filing obligations for several years, the IRS often does not have their correct contact information. As a result, the notices may go to old addresses, leaving taxpayers with little or no opportunity to arrange payments with the IRS before being subjected to a levy. Moreover, the IRS does not send FPLP notices to the addresses of Social Security alternate payees, such as nursing homes or guardians, unless those payees have a Form 2848, *Power of Attorney and Declaration of Representative*, on file with the IRS.

Use of Specific Response Date

When the IRS sends out a Final Notice Before Levy on Social Security Benefits (CP 91 or 298 notice), the taxpayer has 30 days to respond.[11] To improve notice clarity, the

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5 *See* IRM § 5.11.6.1.1. A manager may approve a manual levy that could attach more than the 15 percent through FPLP. In practice, the extra work and the uncertain proceeds usually make FPLP a more popular option.

6 IRC § 6331(h)(2)(A); IRM § 5.11.7.2 (Rev. 7-26-2002). Payments subject to the FPLP include any federal payments other than those for which eligibility is based on the income or assets of the recipients. Thus, SSI payments (for which eligibility is based on the income) are not subject to continuous levy under the FPLP, while OASDI payments (which are not means-tested) fall within the purview of the FPLP.

7 The FMS is the Department of the Treasury agency that processes payments for various federal agencies.

8 IRM § 5.19.9.3.2.7 (Rev. 7-14-2005): CP 90/297, Notice of Intent to Levy and Notice of Your Right to a Hearing.

9 IRM § 5.19.9.3.2.7(5) (Rev. 7-14-2005): CP 91/298, Final Notice Before Levy on Social Security Benefits.

10 IRM § 5.19.9.3.2.8(2) (Rev. 7-14-2005).

11 Treas. Reg. § 301.6331-2(a)(1) provides that the levy may be made no less than 30 days after notice of intent to levy.

National Taxpayer Advocate recommends that the IRS include a specific due date for response, given the nature of the population receiving these notices.

The IRS has declined to use a specific due date on the grounds that taxpayers would be confused if the date specified fell on a federal holiday. We strongly believe that taxpayers will recognize that when a response is due on a holiday (or a weekend, for that matter), it will be reasonable to wait until the next business day. We urge the IRS to reconsider this recommendation to use a specific date on CP 91 and CP 298 notices.

Inadequate Safeguards to Exclude Low Income Taxpayers

Levies on Social Security benefits can cause particularly severe hardships for low income taxpayers, despite commendable IRS efforts to identify and exclude low income and other at-risk taxpayers from the program. A significant number of Social Security recipients rely on these payments as their primary or even their only source of income.

- In August 2005, Social Security recipients received an average monthly benefit of $877.20;[12]
- Social Security provides at least half of the total income for 65 percent of beneficiaries aged 65 and over, and is the only source of income for more than 20 percent of this population;[13]
- The median income for seniors aged 65 and over was $24,509;[14] and
- The poverty rate for seniors aged 65 and over was 9.8 percent in 2004.[15]

Because recipients of SSA payments rely so heavily on their benefits, even a slight reduction in income may cause hardship to many seniors. The IRS recognized this potential for harm and, working with the National Taxpayer Advocate, established a mechanism to identify taxpayers who might experience significant hardship if levied under the FPLP. In January 2002, the IRS put in place a filter to systemically exclude from the levy program certain SSA recipients with income below an established threshold. This exclusion was based on the total positive income (TPI) reported on the

[12] Social Security Administration Office of Policy, Research, Evaluation and Statistics, *Monthly Statistical Snapshot,* Table 2, Social Security Benefits (August 2005).

[13] Social Security Administration, *Fast Facts & Figures About Social Security, 2005* (September 2005).

[14] U.S. Census Bureau, *Income, Poverty, and Health Insurance Coverage in the United States: 2004,* available at http://www.census.gov/hhes/www/income/income04/.

[15] U.S. Census Bureau, *Current Population Survey, 2005 Annual Social and Economic Supplement,* available at http://www.census.gov/hhes/www/poverty/poverty04/. The Census Bureau uses a set of income thresholds that vary by family size and composition to determine who is in poverty. The poverty guidelines issued each year in the *Federal Register* by the Department of Health and Human Services may differ from the Census Bureau's poverty threshold.

taxpayer's last filed federal tax return.[16]

However, the TPI criterion was imperfect at best. Because the TPI calculation was based on a taxpayer's last filed return and did not necessarily represent his or her current financial condition, the TPI criterion was both under-inclusive and over-inclusive. Some taxpayers may have reported relatively little income on their last filed returns, yet have substantial assets and the ability to pay the tax. Conversely, other taxpayers who reported high incomes on their last filed returns may now lack the wherewithal to pay.

The General Accounting Office (GAO, now the Government Accountability Office) concluded in a 2003 study that the TPI criterion is "an inaccurate indicator of a taxpayer's ability to pay."[17] In response to this report, the IRS convened a cross-functional task force to develop alternatives to the TPI criterion. This task force, organized in 2003, has struggled to come up with a reliable, systemic method of predicting current economic hardship. The National Taxpayer Advocate urges the IRS to continue searching for a method of excluding low income taxpayers from the FPLP. One possible solution would be to evaluate interest and dividend income received by Social Security beneficiaries to develop assumptions about their ability to pay.[18]

In June 2005, the IRS stopped using the TPI to predict hardship status. It is estimated that this change will impact an additional 90,000 Social Security beneficiaries.[19] These additional FPLP levies may result in economic hardships to the taxpayers if safeguards are not in place.

We note that the IRS could entirely avoid the problem of identifying low income taxpayers if tax debts were treated like other federal payments. For nontax federal debts, the first $750 per month ($9,000 per year) of federal benefits is statutorily exempt from levy.[20] Because the FPLP is used to satisfy tax debts, however, the IRS may levy on the first dollar of Social Security benefits, regardless of the amount. If tax debt were treated like other federal debt, Social Security recipients would be entitled to exclude a mini-

[16] TPI is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual income tax return: wages; interest; dividends; distributions from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as a zero. IRM Exhibit 4.1.7-1(33).

[17] General Accounting Office, GAO 03-356, *Tax Administration, Federal Payment Levy Program Measures, Performance and Equity Can Be Improved* 11 (March 6, 2003).

[18] One possible approach would require the IRS to determine taxpayers' total positive income in the last two years (by looking at filed tax returns or Forms 1099). If the only income is from the SSA, the IRS would not levy. If the income is from the SSA plus dividends and interest under "x" amount, or from wages under "y" amount, the IRS would also not levy.

[19] http://www.irs.gov/advocate.

[20] Debt Collection Improvement Act of 1996, Pub. L. No. 104-134 (1996).

mum of $9,000 per year in benefits from IRS levy[21]

Lack of Managerial Approval

One of the appealing features of the FPLP is that it is an automated matching program requiring minimal oversight from IRS collection employees. However, automation does not guarantee error-free processing.[22] If the IRS erroneously places a levy on a taxpayer's Social Security payments, the taxpayer will face an undue burden, since Social Security recipients often rely heavily on that income for necessary living expenses. The IRS may spend more resources undoing improper levies than it would have spent if a manager reviewed at least some of the proposed levies. It is less than clear that this automated system results in overall efficiency for the IRS.

To protect taxpayers from unnecessary hardship, Congress instructed the IRS to develop procedures to ensure a determination to file a levy would, where appropriate, be reviewed by a supervisor before the levy action was taken. Section 3421 of the IRS Restructuring and Reform Act of 1998 (RRA 98) requires that a supervisor, where the Secretary deems appropriate, take the following steps prior to the issuance of a levy: (1) review the taxpayer's information; (2) verify that a balance is due; and (3) affirm that the action proposed to be taken is appropriate given the taxpayer's circumstances, considering the amount due and the value of the property or right to property.[23]

In accordance with this instruction, Delegation Order 5-3 sets forth the procedures for approving levies.[24] Delegation Order 5-3 requires approval at certain levels of management prior to levying on Social Security payments.[25] Although IRS guidelines regarding

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[21] *See* Additional Legislative Recommendation: *Social Security Levies, infra.*

[22] For example, a disabled taxpayer with a balance due of $133 was subjected to an FPLP levy. She earned $35 per month working part-time (due to her disability, her employment prospects are limited) and relied primarily on OASDI payments from the SSA to pay for her living expenses. Because there is no provision for discretion or managerial review, the IRS levied the taxpayer's disability payments under the FPLP. The taxpayer, unable to make her rent payments or even to purchase groceries, came to TAS for assistance. *See* Taxpayer Advocacy Management Information System (TAMIS).

[23] Section 3421 of the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998) provides as follows:

(a) IN GENERAL.–The Commissioner of Internal Revenue shall develop and implement procedures under which–

(1) a determination by an employee to file a notice of lien or levy with respect to, or to levy or seize, any property or right to property would, where appropriate, be required to be reviewed by a supervisor of the employee before the action was taken; and

(2) appropriate disciplinary action would be taken against the employee or supervisor where the procedures under paragraph (1) were not followed.

(b) REVIEW PROCESS.–The review process under subsection (a)(1) may include a certification that the employee has–

(1) reviewed the taxpayer's information;

(2) verified that a balance is due; and

(3) affirmed that the action proposed to be taken is appropriate given the taxpayer's circumstances, considering the amount due and the value of the property or right to property.

[24] IRC § 6331(h) authorizes the IRS to issue a continuous levy "[i]f the Secretary approves."

[25] Delegation Order 5-3 (Rev. 9-22-2005), §§ 8, 9.

FPLP make reference to Delegation Order 5-3, they omit the order's requirement for supervisor approval prior to processing FPLP levies.[26]

At first glance, it appears there is a conflict between the provisions TRA 97 authorizing continuous levies under the automated FPLP and the provisions of RRA 98 requiring managerial review prior to the processing of levies. Typically, when two pieces of legislation are in conflict, the latter piece is given greater deference because one can conclude that the legislators were aware of the earlier measure and chose to override any conflicting provisions.[27] However, one must give effect to both statutes to the extent possible.[28]

The National Taxpayer Advocate believes it is possible to reconcile the provisions of TRA 97 and RRA 98. Congress recognized the value of an automated levy program and authorized the FPLP in TRA 97. However, Congress was also concerned enough about the potential harm to taxpayers caught in the system that it directed the IRS in RRA 98 to develop some sort of review system for all levies. Reading the two statutory provisions together, it is apparent that Congress intended the IRS to continue with the automated FPLP levies, but also to institute some type of review process for all levies (including FPLP levies).

Given the potential harm to taxpayers, and Congress' clear intent to minimize that harm by requiring managerial reviews, it is appropriate for the IRS to devise procedures that identify cases that need greater scrutiny before being processed as an FPLP levy. It is up to the IRS to consider what type of review is appropriate for FPLP cases, but some type of mechanism should be in place to protect taxpayers who suffer from financial hardship, especially now that there is no income filter that systematically screens out low income taxpayers. Understandably, it will not be feasible for the IRS to require manual review of all FPLP cases, as that would defeat the purpose of having an automated levy program. Perhaps the IRS can use automation to identify potential high-harm cases (e.g., where IRS records indicate that a taxpayer's income is derived solely from the SSA or where there is an alternate payee for Social Security benefits on file, such as a nursing home) and require managerial review in those cases.

Inadequate Outreach & Education Strategy

In the absence of safeguards for taxpayers with economic or other hardships, the IRS needs to bolster its communication strategy for the FPLP. We urge the IRS to conduct additional outreach as early as possible, targeted to those most likely to receive FPLP notices.

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26 IRM § 5.11.1.2.4(1) (Rev. 7-01-2004).

27 As the Supreme Court has explained: "[I]n interpreting a statute a court … must presume that a legislature says in a statute what it means and means in a statute what it says there." *Connecticut Nat'l Bank v. Germain,* 503 U.S. 249, 253-254 (1992). *See also United States v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 241-242 (1989); *Whitney v. Robertson,* 124 U.S. 190, 194 (1988); *United States v. Hansen,* 772 F.2d 940, 944-45 (D.C. Cir. 1985). Note that the provisions in RRA 98 requiring managerial review of levies came about after the provisions in TRA 97 authorizing continuous levies under the FPLP.

28 *See Connecticut Nat'l Bank v. Germain,* 503 U.S. 249, 253 (1992).

TAS developed an outreach strategy targeting the population likely to receive FPLP levies aimed at SSA benefits, since these taxpayers are likely to experience economic hardship and thus qualify for TAS assistance. TAS, in conjunction with the Wage & Investment division and other key stakeholders, developed a consumer tax alert brochure, a PowerPoint presentation, and a fact sheet discussing changes to the FPLP program and how the changes may affect taxpayers receiving Social Security benefits. This brochure has been disseminated via multiple channels, including the AARP, Low Income Taxpayer Clinics, and the Taxpayer Advocacy Panel.

The IRS should not merely rely on TAS outreach and education efforts. The IRS, on its own and through stakeholders, needs to let taxpayers know how changes in the FPLP rules may affect them, and where to find assistance. Stakeholders, Partnerships, Education, and Communication (SPEC), the IRS organization responsible for education of individual (*e.g.*, non-business) taxpayers, should develop contacts and educational materials for those affected by FPLP. The National Taxpayer Advocate recommends that SPEC partner both locally and nationally with stakeholders such as the AARP and elder care facilities (*e.g.*, nursing homes, assisted living centers, and retirement communities) to spread the message.

Selective Use of FPLP to Target Vulnerable Population

The FPLP is intended to encourage tax compliance among individuals and businesses receiving federal payments. Taxpayers subject to levy under the FPLP include federal contractors whose payments are processed by the FMS, recipients of federal retirement payments from the Office of Personnel Management, and recipients of Social Security payments.[29] Yet in practice, the overwhelming majority of FPLP levies involve benefit payments administered by the SSA. An astonishing 79 percent of the FPLP levies issued in fiscal year 2005 involved SSA payments.[30] Over the last four fiscal years, 84 percent of FPLP levies issued were from SSA recipients.[31]

The IRS seemingly recognizes that those receiving SSA payments are more likely to experience financial hardship, as its guidance suggests levying on Social Security income should be a last resort.[32] Yet the IRS disproportionately utilizes its FPLP authority primarily to aid its collection efforts against the segment of the population receiving Social Security benefits.

29 IRM § 5.19.9.3.1 (Rev. 7-14-2005).

30 Per email message from W&I Payment Compliance, Acting Sr. Program Manager, dated September 28, 2005. 656,000 SSA Levies/832,000 Total Levies = 78.9 percent.

31 Per email message from W&I Payment Compliance, Acting Sr. Program Manager, dated September 28, 2005. 331,946 (FY02 SSA Levies) + 477,434 (FY03 SSA Levies) + 562,000 (FY04 SSA Levies) + 656,000 (FY05 SSA Levies)/382,887(FY02 Total Levies) + 521,390 (FY03 Total Levies) + 671,000 (FY04 Total Levies) + 832,000 (FY05 SSA Levies) = 84.2 percent.

32 IRM § 5.19.9.3.3(2) (Rev. 7-14-2005).

Need for Improved Training of Employees

The IRS needs to keep in mind the need for taxpayer service within its enforcement measures. A 2002 TAS research study showed that the underserved population of taxpayers is not homogenous, but can be broken down into several distinct segments, each with differing demographic and psychographic characteristics.[33] The IRS should conduct similar research on the unique needs of the population of taxpayers receiving OASDI payments. Once it identifies the needs of this segment, the IRS should provide its employees with specific guidance to ensure that it provides the appropriate level and type of taxpayer service.

Manual Levies

Under prior IRS guidance, manager approval was required for manual levies in excess of 15 percent of the Social Security payment.[34] Now, the only restriction is that the taxpayer is to be left with some minimum amount of exempt income.[35] Under the current rules, it is possible for manual levies to reach 100 percent of a taxpayer's OASDI payments if he or she has other sources of income.

IRS guidelines state that a manual levy on Social Security income should be a last resort, in part because issuing levies through the FPLP is less labor intensive.[36] An FPLP levy takes precedence over a manual levy.[37]

OASDI Payments: Retirement Asset or Retirement Income?

The IRS acknowledges it should exercise particular care before levying on retirement assets. For example, the IRS will not levy on retirement assets, such as an IRA, unless the taxpayer has engaged in "flagrant" conduct.[38] However, there is no similar restriction for levies on retirement *income*, as current IRS procedures allow manual levies on OASDI payments even in cases that are not flagrant.[39]

The IRS's rationale for levying on a series of OASDI payments using a single manual levy is that this series of payments is a single retirement asset (consisting of a fixed and

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33 Russell Marketing Research, *Findings from Task 149 – The Taxpayer Advocate Service Research Program with a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3* (July 2002).

34 IRM § 5.19.9.4.1.1(6) (Rev. 12-29-2003) provides that a "manager may approve a manual levy to SSA that could attach more than the 15 percent through FPLP."

35 The term "exempt amount" is calculated by adding the standard deduction and the aggregate amount of dependent exemptions. For example, a single taxpayer who is paid weekly and claims three exemptions (including one for the taxpayer) will be able to exempt $14,600 from levy ($280.77 per week). *See* IRC § 6334(a)(9); Treas. Reg. § 301.6334; Publication 1494 (Rev. 2005).

36 IRM § 5.19.9.3.3 (Rev. 7-14-2005).

37 IRM § 5.11.7.2.5.5(3) (Rev. 7-26-2002).

38 IRM § 5.11.6.2(5) (Rev. 3-15-2005).

39 IRM § 5.17.3.2.1(4) (Rev. 10-31-2000) provides that "[l]evies on pension benefits seize a taxpayer's current right to payments…and are no longer restricted to cases of flagrant noncompliance."

determinable property right to future benefits).[40] If the IRS views OASDI payments as being a retirement asset, then the IRS should limit manual levies on OASDI payments to flagrant cases, as it does on levies on other retirement assets. On the other hand, if the IRS wishes to treat OASDI payments as retirement income, then it should levy no more than 15 percent of such payments pursuant to IRC § 6331(h). Instead, it appears that the IRS is having its cake and eating it, too, by treating OASDI payments as both a retirement asset and as retirement income, depending on its particular objective.

Payments Subject to Double Levy

Under IRS procedures, the same payment source should not be subject to both an FPLP levy and a manual levy.[41] However, TAS has encountered a number of cases where the IRS applied manual levies *in addition* to FPLP levies on the same payment.[42] Taxpayers may experience unnecessary hardship when the IRS imposes manual levies before FPLP levies cease.

Situations where taxpayers are subject to both continuous levies and manual levies should not occur. IRS guidelines clearly state that "[i]f a paper levy is issued to a federal agency while the taxpayer is being levied through the FPLP for the same payment, the federal agency will return the paper levy to the originator."[43] The fact that some taxpayers are in fact subject to double levy indicates a lack of training or oversight of IRS collection employees. The IRS needs to ensure its employees follow the procedures set forth in the IRM.

Delay in Releasing Levies

Levy releases are not always processed promptly, and taxpayers may suffer hardship because of the difficulty of obtaining a release of manual levies from the SSA. Although TAS has been working with the SSA to expedite releases, the SSA can still take up to three months to process IRS levy releases while it continues to send payments to the IRS. This delay causes the IRS to process multiple manual refunds to return these payments in cases when the taxpayer is experiencing financial hardship.

The SSA has no automated processing system for levies and releases. Employees must manually input all documents at seven processing centers around the country, which all have their own programs and procedures. Nor does the SSA have a required timeframe

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40 *See* IRM § 5.6.11.1(3) (Rev. 6-29-2001); IRM § 5.17.3.5.24(3) (Rev. 10-31-2000); Rev. Rul. 55-210, 1955-1 C.B. 544 (only one notice of levy needs to be served to effectively reach vested benefits subsequently payable in other contexts).

41 *See* IRM § 5.19.9.3.3 (Rev. 7-14-2005). If an FPLP levy is already in place, the IRS can issue a manual levy on other levy sources, but not the same FPLP levy source.

42 *See* TAMIS (taxpayer was subject to FPLP levies of $152.02, $99.37, and five payments of $102.49 from December 2004 to June 2005 while concurrently subject to manual levies of $640.50, $665.50, and five payments of $644.67); TAMIS (in October 2004, taxpayer subject to FPLP levy of $89.29 and manual levy of $739.70; TAMIS (in December 2004, taxpayer subject to FPLP levy of $77.86 and manual levy of $636.90).

43 IRM § 5.11.7.2.5.5(3) (Rev. 7-26-2002).

for processing levy releases.

The Taxpayer Advocate Service and the SSA have reached an interim solution, under which the SSA has agreed to expedite levy releases for taxpayers experiencing financial hardships, and has provided an updated list of contacts and fax numbers for the seven Processing Centers. The Small Business/Self-Employed division management has alerted Automated Collection System (ACS) sites to the problem and instructed employees to follow the procedures in IRM § 5.19.4.4.12 for faxing levy releases immediately when these situations arise. While this interim solution has seemed to work, the IRS should continue to partner with the SSA and FMS to develop permanent procedures that will ensure prompt processing of levy releases.

IRS COMMENTS

Understanding the sensitive nature of levying Social Security benefits, we believe both Congress, in enacting legislation authorizing the levy, and the Service carefully scrutinized the administration of this authority in the development of both the Federal Payment Levy Program (FPLP) and manual (paper) levy operational procedures.

Managerial Approval and Continued External Oversight

We believe sufficient managerial approval and oversight exist in the administration of the FPLP, in both the authority to levy a taxpayer's case and the notification to the taxpayer. Because of its intended automated environment, the types of taxpayer cases systemically selected into the FPLP are carefully considered and subjected to many levels of review. These cases include taxpayers with unresolved tax accounts receiving Social Security benefits. Because the FPLP allows for a large number of taxpayer cases that may be subjected through an efficient levy process, Congress limited the FPLP levy to 15 percent of the federal payment. Also, in order for SSA taxpayers to have additional time to resolve their accounts prior to being levied through the FPLP, they are provided an additional pre-levy notice (in addition to the statutory due process notice provided to all taxpayers subject to any levy.) These special notices identify their specific Social Security benefit subject to levy.

In addition, GAO continues to administer additional oversight over the FPLP, including the review of the operational policies on Social Security levies as the Advocate's report cites. Also, representatives from the IRS, along with Financial Management Service (FMS), briefed Congressional Social Security subcommittee members during the ongoing development phase of the FPLP's Social Security levies.

While the decision to issue manual paper levies is no longer under a "flagrant case only" standard, managerial approval is still necessary due to the nature of the levied benefit. Also, part of the benefit may be statutorily exempt from a manual paper levy. In order to improve the quality of the administration of these levies, we continue to work with the SSA to lessen the burden that these levies may have on taxpayers. One major system enhancement will eliminate the operational error of double levies on a benefit and will be in operation in 2006. We continue to work with SSA to ensure levy releases on manual paper levies are efficiently and promptly released.

Potential Financial Hardship

While a levy may place a financial hardship on some taxpayers, the 2003 GAO audit report cited in the Advocate's report found that a small number of taxpayer's face financial hardships as a result of FPLP actions. A separate FPLP statistical report revealed that there were significantly more SSA taxpayers who fully paid their accounts or were placed in an installment agreement, than those who claimed a financial hardship.

Based on this information regarding financial hardship and the fact that separate GAO and IRS studies found the income exclusion criterion was inaccurate, we agreed with the GAO recommendation to eliminate the exclusion criterion and rely on the additional final notice process to resolve taxpayer cases. The Taxpayer Advocate Service was represented on the cross functional group that participated in this decision.

The income exclusion criterion will be eliminated in January 2006, and the IRS will continue to monitor the results stemming from FPLP actions on taxpayers whose Social Security payments are levied.

Response to *Notice Language Clarity and SPEC Outreach and Education* Recommendations

Last year, the IRS and TAS staff worked together to enhance the language of the FPLP's additional pre-levy Social Security notice. As the Advocate's report indicates, one outstanding issue was to determine if a specific date should be indicated on the notice by when the taxpayer needed to respond. After careful consideration, IRS decided that this notice would conform with all other IRS notices that follow a formal notice clarity process where it is not the standard to define a specific deadline date, but rather provide how much time the taxpayer has to respond.

Prior to adding Social Security levies to the FPLP, the IRS published a news release encouraging taxpayers to resolve their accounts in order to avoid such actions. The SSA and FMS also provided news content to the public through their venues. IRS believes sufficient information has been provided to the public and interested stakeholders based on the relatively low volume of impact that these levies may have compared to the millions of taxpayers who receive Social Security benefits.

While we feel we have taken the appropriate actions to educate our customers, we will review options for Stakeholder, Partnership, Education, and Communication (SPEC) partnering both locally and nationally with various stakeholders to further educate our customers on how changes in the FPLP rules affect them and where to find assistance.

Conclusion

The IRS recognizes the National Taxpayer Advocate's efforts to ensure that these taxpayers are well protected under adverse situations such as a levy, but the IRS has and will always ensure that the administration and operation of any levy program follow all taxpayer rights and provide for mutual taxpayer case resolution. This would include deeming an account uncollectible if a financial hardship exists based upon the taxpayer's response to the pre-levy notification as well as after the levy has been effected.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the IRS for the many improvements to its levy process. In particular, she is pleased with the IRS's continuing efforts to improve clarity in taxpayer correspondence and its commitment to work with stakeholders to educate taxpayer regarding changes to the program. The IRS should distribute TAS' revised FPLP brochure for Social Security recipients when it becomes available again.

However, the National Taxpayer Advocate questions the IRS claim that "the types of taxpayer cases that are systematically selected into the FPLP are carefully considered and subject to many levels of review." The experiences of TAS and Low Income Taxpayer Clinics when they intercede on behalf of taxpayers facing hardship indicate that the current system of review can be improved.

The National Taxpayer Advocate is especially concerned that the IRS, despite its best efforts, has been unable to devise a method of screening out low income taxpayers from the FPLP. Effective screening eliminates the need for these elderly or disabled taxpayers to call the IRS and seek relief from a levy. Thus, the National Taxpayer Advocate recommends that Congress exempt Social Security payments from the FPLP, or in the alternative provide an automatic statutory exemption amount for Social Security recipients.[44] Pending legislative action, the IRS should explore developing an algorithm for screening out low income taxpayers from FPLP and manual levies on Social Security benefits. This algorithm could be based on the taxpayer's total positive income and Information Return Program (IRP) data. Moreover, the IRS should work with the Social Security Administration to develop a method of identifying Social Security payments made to Alternate Payees such as nursing homes.

The National Taxpayer Advocate would also like to emphasize the need for the IRS to improve training for all employees who deal with the release of levies and return of levy proceeds. TAS case advocates are trained to help taxpayers who need assistance resolving their Social Security levy issues with the IRS, but operating division employees must also be able to recognize hardship and take immediate action.

[44] *See* Additional Legislative Recommendation: *Social Security Levies, infra.*

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations:

- The IRS should include a specific due date for response for CP 91 and CP 298 notices.
- The IRS to continue should develop an algorithm for screening out low income taxpayers from FPLP and manual levies on Social Security benefits.
- The IRS should come up with procedures to identify cases that need greater scrutiny before being processed as an FPLP levy.
- The IRS, on its own and through stakeholders, needs to let taxpayers know how changes in the FPLP rules may affect them, and where to find assistance.
- The IRS should conduct research on the unique needs of the population of taxpayers receiving OASDI payments and provide its employees with specific guidance to ensure that it provides the appropriate level and type of taxpayer service.
- The IRS should limit manual levies on OASDI payments to flagrant cases, as it does on levies on other retirement assets, or in the alternative, it should levy no more than 15 percent of such payments.
- The IRS should ensure that its employees follow the procedures set forth in the IRM so that taxpayers are not subject to double levy.
- The IRS should continue to partner with the SSA and FMS to develop permanent procedures that will ensure prompt processing of levy releases.

PROBLEM

TOPIC #7 MOST SERIOUS PROBLEM: APPEALS CAMPUS CENTRALIZATION

RESPONSIBLE OFFICIAL

David B. Robison, Chief of Appeals

DEFINITION OF THE PROBLEM

In the 2004 Annual Report to Congress, the National Taxpayer Advocate reported that one of the most serious problems facing taxpayers was the erosion of independence in the IRS Office of Appeals (Appeals), and raised concerns about Appeals' Campus Centralization Initiative.[1] Under this initiative, Appeals has centralized case inventory from certain workstreams at six IRS campuses.[2] With campus centralization, Appeals hopes to improve case cycle time and increase efficiency by "getting the right work to the right employee."[3] Cases that would have been worked in Appeals field offices will now be transferred to the applicable IRS campus – generally without regard to taxpayers' geographic locations. Thus, a case could be worked by an Appeals employee in a location distant from the affected taxpayer or the taxpayer's representative.

Appeals campus centralization may indeed reduce Appeal case cycle time (although that is yet to be determined conclusively). However, Appeals campus centralization also has the potential to negatively impact taxpayers by:

- Reducing face-to-face or local office conference opportunities;
- Diminishing working relationships between Appeals' employees, taxpayers, and taxpayer representatives and increasing taxpayer burden when cases are worked outside of a taxpayer's geographic area;
- Moving work that has traditionally required a high level of independent judgment and discretion to an environment that has traditionally focused on processing; and
- Diminishing service and effectively eliminating appeal rights for low income and less sophisticated taxpayers.

1 National Taxpayer Advocate 2004 Annual Report to Congress 264, 269-272.

2 IRS Campuses were formerly known as IRS Service Centers.

3 Appeals Strategy and Program Plan, FY 2005-2006. Appeals has updated this strategy to provide, "getting the right work to the right employee at the right time to get the right decision." *Appeals Strategy and Program Plan*, FY 2006-2009 2.

BACKGROUND

Campus Centralization

Appeals began centralizing certain workstreams at IRS campuses in late 2003 and early 2004.[4] Appeals' campus centralization objectives are to:

- Improve case cycle time by shifting the large inventory of casework in Appeals field offices to the campuses.[5]
- Increase customer satisfaction by resolving high volumes of work earlier in the process.[6]
- Increase Appeals' operating cost effectiveness.[7]
- Achieve greater efficiency through specialization.[8]
- "Get the right work to the right employee" – *i.e.*, match the case work to the skills and grade level of the individual employee.[9]
- Work less complex cases in Appeals campuses to "resolve [a] high volume of less complex work earlier" and to "more effectively work [the] most complex cases . . . in the field, … [which] is best equipped to do that complex work."[10]
- Work cases in the campuses that are generated in the campuses and allow Appeals field employees to work cases generated by field compliance.
- Dedicate staffing to time sensitive workstreams (such as economic hardship cases).[11]

Appeals believes that campus case centralization makes sense in large part because almost two-thirds of Appeals' cases are generated by campus compliance functions. Table 1.7.1 shows Appeals receipts by both workstream and source (*i.e.*, cases generated by IRS campuses vs. cases generated by IRS field offices) for fiscal year (FY) 2005.

4 Diane Hiser and Ray Wolff, *Welcome Aboard, Brookhaven Appeals Campus!*, IRS Office of Appeals, Friday Report (October 17, 2003). Ray Wolff, *New Campus Teams = Employee Satisfaction*, IRS Office of Appeals Friday Report (April 9, 2004).

5 *Id.*

6 David B. Robison, *Appeals: Dedicated to Continuous Improvement*, J. Tax Practice and Procedure (Feb.-Mar. 2005), 59, 61.

7 Diane Hiser and Ray Wolff, *Welcome Aboard, Brookhaven Appeals Campus!*, IRS Office of Appeals, Friday Report (October 17, 2003).

8 *Id.*

9 SB/SE Executive Conference Presentation Materials (5/5/2005); *Appeals Strategy and Program Plan*, FY 2005/2006.

10 SB/SE Executive Conference Presentation Materials (5/5/2005); *Appeals Strategy and Program Plan*, FY 2005/2006; IRS/TEI Night Presentation Materials (3/17/2005); Videotape: *Update on Campus Rollout*. By David Robison and Ray Wolff, Web Stream Broadcasting (3-1-2005).

11 IRS Office of Appeals, FY 2005 Campus Implementation, Taxpayer Advocate Briefing (March 31, 2005).

PROBLEMS

TABLE 1.7.1, FY 2005 APPEALS RECEIPTS (BY SOURCE AND WORKSTREAM)[12]

Workstream	Cases from Field	Percent of Total	Cases from Campuses	Percent of Total
Penalty Appeals	1,764	13%	11,939	87%
Offers In Compromise (OIC)	6,573	44%	8,361	56%
Collection Due Process (CDP)	9,508	32%	20,302	68%
Innocent Spouse	149	4%	3,192	96%
Exam Nondocketed	7,940	61%	5,037	39%
Exam Docketed – Regular Cases	1,951	29%	4,783	71%
Exam Docketed – S Cases[13]	2,522	21%	9,303	79%
Coordinated Industry Cases (CIC)[14]	552	100%	0	0%
Industry Cases (IC)	750	100%	0	0%
Other	5,094	96%	198	4%
TOTAL	**36,803**	**37%**	**63,115**	**63%**

In an attempt to increase efficiency, Appeals is now operating at IRS campuses in Fresno; Ogden, Utah; Philadelphia; Brookhaven; New York; Memphis; and Covington, Kentuckey (Cincinnati). Campus Appeals works both campus-generated cases and cases generated elsewhere. Campus Appeals currently works campus-generated penalty appeals, offer in compromise (OIC), Collection Due Process (CDP), nondocketed exam, and innocent spouse cases. Campus Appeals also works Tax Court docketed exam cases (including docketed "S" cases), and Freedom of Information Act (FOIA) request cases. Table 1.7.2 summarizes Appeals' campus operations by workstream type and source, and notes when each Appeals campus office began operations.

[12] Appeals Centralized Database System (ACDS), Appeals Receipts Reports – FY 2005 (October 7, 2005).

[13] Cases docketed in the United States Tax Court with a deficiency of $50,000 or less (including tax and penalties) for a taxable period, where the petitioner elects to be treated under small case procedures. IRC § 7463.

[14] Formerly called Coordinated Examination Program (CEP) cases.

TABLE 1.7.2, CENTRALIZED CAMPUS SOURCE CASE ROUTING BY APPEALS CAMPUS OFFICE[15]

Campus	Workstream(s)	Source(s)
FRESNO (December 2004)	Exam "S" Docketed	Austin, Kansas City, Fresno, Cincinnati
	Exam Nondocketed	Austin, Kansas City, Fresno, Cincinnati
	CDP	Fresno, Kansas City
	FOIA	Fresno
OGDEN (September 2004)	Penalty Appeals	Austin, Fresno, Kansas City, Memphis, Ogden
PHILADELPHIA (1988)	Exam "S" Docketed	Philadelphia
	Exam Nondocketed	Philadelphia
BROOKHAVEN (October 2003)	Penalty Appeals	Andover, Atlanta, Brookhaven, Cincinnati, Philadelphia
	Exam "S" Docketed	New York zip codes only from: Andover, Brookhaven
	OIC	Brookhaven
MEMPHIS (April 2005)	OIC	Memphis
COVINGTON (December 2003)	Innocent Spouse	Cincinnati

Table 1.7.3 shows Appeals assignments (*i.e.*, cases assigned to Appeals campus offices vs. Appeals field offices) for FY 2005.

TABLE 1.7.3, APPEALS CASE ASSIGNMENTS – CAMPUS VS. FIELD (BY WORKSTREAM)[16]

Workstream	Cases assigned to Field	Percent of Total	Cases assigned to Campuses	Percent of Total
Penalty Appeals	2,207	16%	11,496	84%
OIC	10,114	68%	4,820	32%
CDP	23,781	80%	6,029	20%
Innocent Spouse	1,251	37%	2,090	63%
Exam Nondocketed	11,271	87%	1,706	13%
Exam Docketed – Regular Cases	6,685	99%	49	1%
Exam Docketed – S Cases	7,973	67%	3,852	33%
CIC	552	100%	0	0%
IC	750	100%	0	0%
Other	5,083	96%	209	4%
TOTAL	**69,667**	**70%**	**30,251**	**30%**

Naturally, Appeals campus centralization requires enough Appeals employees at each applicable campus to handle the centralized workstreams. According to Appeals, its campus employees will have the same training, the same quality measurement proce-

[15] IRS Office of Appeals, Campus Implementation, Taxpayer Advocate Briefing (March 31, 2005).

[16] Appeals Centralized Database System (ACDS), Appeals Receipts Reports – FY 2005 (October 7, 2005).

dures, and the same measures of success as the rest of Appeals.[17] Table 1.7.4 presents Appeals FY 2005 campus staffing numbers.

TABLE 1.7.4, APPEALS CAMPUS STAFFING – FY 2005[18]

Job Title[19]	Employees as of Oct. 30, 2004	Employees as of Oct. 1, 2005	Gain/(Loss)
Appeals Officers	66	80	14
Settlement Officers	24	63	39
Tax Specialists	30	31	1
Case Screeners	12	24	12
Case Processors (Processing)	8	12	4
Tax Examiners (Processing)	50	75	25
Other	14	35	21
TOTAL	**204**	**320**	**116**

Table 1.7.4 indicates that Appeals campus staff increased by 57 percent in FY 2005. This number includes a 21 percent increase in Campus Appeals Officers (AOs) and a 163 percent increase in Campus Settlement Officers (SOs).

At the same time, however, the number of Appeals field employees greatly decreased. Table 1.7.5 shows Appeals field staffing numbers for FY 2005.

[17] David B. Robison, Chief Appeals, IRS, *"IRS Appeals Service Improvements via a Campus Strategy Approach,"* Vol. 23, No. 5, Enrolled Agent Journal, p. 21, September-October 2005.

[18] Employee Service Record Report (ESRR) for pay periods ending October 31, 2004 and October 1, 2005.

[19] *Appeals Officers* are responsible for handling issues and cases generated by various compliance functions in campus and the field and for arriving at the final dispositions and to approve the final settlements of the cases. *Settlement Officers* are responsible for resolving collection cases generated and referred to Appeals by various compliance components in the campus and in the field. *Tax Specialists* are responsible for resolving tax issues that are generated and referred to Appeals by various campus compliance and accounts management components. *Case Screeners* review new receipts, determine initial case processing, and prepare the administrative file for transfer or reassignment. *Case Processors* provide administrative and clerical support in processing and closing cases. *Tax Examiners* are responsible for reviewing cases, processing adjustments, computing normal interest and simple restricted interest cases, and closing pipeline and special processing cases.

TABLE 1.7.5, APPEALS FIELD STAFFING – FY 2005[20]

Job Title	Employees as of Oct. 30, 2004	Employees as of Oct. 1, 2005	Gain/(Loss)
Tax Computation Specialists[21]	98	94	(4)
Appeals Officers	828	742	(86)
Settlement Officers	217	216	(1)
Tax Specialists	4	4	No Change
Case Screeners	33	28	(5)
Case Processors (Processing)	28	22	(6)
Tax Examiners (Processing)	285	239	(46)
Other	204	185	(19)
TOTAL	**1,697**	**1,530**	**(167)**

Table 1.7.5 shows that overall Appeals *field staffing* decreased ten percent in FY 2005, including a ten percent decrease in AOs, even as Appeals campus staffing increased dramatically. These numbers are unusually high relative to Appeals' 2.0 percent average yearly attrition rate for the past ten fiscal years.[22] In fact, in FY 2005, Appeals' overall staffing remained essentially constant.[23] Looking at the numbers presented in Tables 1.7.4 and 1.7.5, alone, it appears that the net result of Appeals staffing shifts in FY 2005 was about 100 Appeals employees moving from field offices to IRS campuses. More importantly, between campus and field combined, there was a net decrease of 72 Appeals Officers.

Appeals Procedures

Appeals intends to work its campus cases in much the same way that it works field cases. In both the field and campuses, Appeals typically receives a case when: (1) a taxpayer does not agree with the determinations of an IRS compliance function;[24] (2) a taxpayer wishes to Appeal certain IRS collection actions through a Collection Due Process (CDP) hearing or the Collection Appeals Program (CAP);[25] or (3) the IRS Office of Chief Counsel ("Counsel") refers a case docketed in the United States Tax Court to Appeals

20 Treasury Integrated Management Information System (TIMIS) Workforce Reports for pay periods ending October 31, 2004 and October 1, 2005.

21 *Tax Computation Specialists* prepare all complex computations and schedules reflecting adjustments resulting from Appeals or Counsel's disposition of the case. For a description of other listed positions, *see* footnote 19 *supra*.

22 Ten year average calculated based on year end decreases and increases in total Appeals staffing for fiscal years as follows: FY 1995 (2,287); FY 1996 (2,148); FY 1997 (2,148); FY 1998 (2,172); FY 1999 (2,154); FY 2000 (1,943); FY 2001 (1,864); FY 2002 (1,963); FY 2003 (1,838); FY 2004 (1,901); FY 2005 (1,850); TIMIS Workforce Reports and ESRR for pay period ending October 1, 2005.

23 Overall Appeals staffing decreased from 1,901 to 1,850 in FY 2005. IRS Office of Appeals Response to Taxpayer Advocate Service Information Request (Sept. 16, 2005); TIMIS Workforce Reports and ESRR for pay period ending October 1, 2005

24 *See generally*, IRS Pub. 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree* (Rev. 01-1999).

25 *See* IRS Pub. 1660, *Collection Appeal Rights* (Rev. 05-2000), 1987-1 C.B. 720.

for consideration of settlement under Rev. Proc. 87-24.[26]

Appeals cases are forwarded to an Appeals Team Manager (ATM), who evaluates the case for complexity and assigns it to an Appeals Officer (AO) or Settlement Officer (SO).[27] The ATM makes these assignments based on each case's dollar value, issue types, complexity, and workload considerations.[28] The ATM assigns less complex cases to lower graded employees and more complex cases to higher graded employees.

When Appeals accepts a case, it notifies the taxpayer by letter. The type of letter Appeals sends differs by case, but all initial contact letters generally acknowledge Appeals' receipt of the case and instruct the taxpayer to contact Appeals to arrange a conference. Some initial contact letters pre-schedule a conference by instructing the taxpayer to call the AO or SO at a specific date and time. In docketed cases, the initial contact letter acknowledges that the taxpayer has filed a Tax Court petition and notifies the taxpayer that the case has been referred to Appeals for settlement.[29] After a taxpayer receives the initial contact letter and contacts Appeals, Appeals and the taxpayer work together to try and settle the case.

Docketed "S" Case Procedures

A docketed S case is a case docketed in the United States Tax Court with a deficiency of $50,000 or less (including tax and penalties) for a taxable period and elects to be treated under the Court's small case procedures.[30] S cases are more informal than other docketed cases and are given expeditious consideration by the Tax Court. The Tax Court's decisions in S cases are final and cannot be appealed.[31]

Under Rev. Proc. 87-24, Counsel is to refer most docketed Tax Court cases that have not yet received Appeals consideration – including S Cases – to Appeals for settlement.

[26] 1987-1 C.B. 720; *see* discussion below.

[27] IRS Office of Appeals, *Overview of Appeals Case Work*, Training Document No. 6137-002 (06-2003).

[28] *See* IRM § 8.1.4.2 (Dec. 18, 2001) and Appeals ATM Reference Guide at 71. Cases are initially graded based on "work unit dollar value." A work unit dollar value is computed by determining the amount of deficiency and penalty, overassessment, or the amount of claim on all tax years/periods included in the work unit. IRM § 8.1.4-1 (Dec. 18, 2001). Once the work unit dollar value is determined, cases are initially graded as follows: GS-11: $1-300; GS-12: $301-6,000; GS-13: $6,001-99,999; GS-14: $100,000 or higher. IRM § 8.1.4.2.2.1 (Dec. 18, 2001). ATMs also consider other factors when grading cases, including factual complexity, legal complexity, impact of case, and the Appeals employee's conferencing and negotiating skills. IRM 8.1.4-2 (Dec. 18, 2001). For example, a GS-11 employee can expect to be assigned cases with established or easily determined facts that impact limited parties and tax years and that have no legal disputes, or are governed by clear legal principles, and that require "normal meet and deal skills." On the other hand, a GS-14 employee will be assigned cases with very complex or novel factual issues with conflicting interpretations that impact numerous unrelated taxpayers or entire industries, or that have "high potential for adverse impact on overall voluntary compliance" that involve very complex applicable law requiring extensive legal research and that require "exceptional conferencing and negotiating skills." *Id.*

[29] Letter 3808(CG) *(S-Docketed Initial Contact Letter)* (Rev. 8-2005).

[30] IRC § 7463; U.S. Tax Ct. R. 170; IRM § 8.4.1.1.1 (June 1, 2002).

[31] *Id.*

Appeals generally has sole settlement authority over docketed S cases until it returns a case to Counsel. Appeals returns docketed S cases to Counsel when a case appears on the Tax Court trial calendar.[32]

Although Appeals is centralizing several workstreams at IRS campuses, it has developed separate written campus procedures for docketed S cases only. Appeals is working docketed S cases in the Fresno, Brookhaven, and Philadelphia campuses.[33]

Appeals intends to work campus docketed S cases in a similar manner to field docketed S cases.[34] There are, however, some differences. One difference is that campus Appeals will only work cases graded at the GS-12 level or lower.[35] All higher graded cases will be assigned to the field. Another difference is the addition of campus S case screeners ("Screeners"). Screeners are GS-9 level Appeals employees who review new case receipt files to make sure they are complete and determine if there is any additional information that would be helpful or relevant to resolve the case.[36] Screeners also set appointments for conferences, perform pre- and post-decision analysis, prepare some case write-up, and set the AO's prescheduled telephone conference calendars.[37]

According to Appeals Campus docketed S case written procedures, Screeners can also resolve certain cases on their own without sending the case to an AO.[38] These proce-

[32] Rev. Rul. 87-24, 1987-1 C.B. 720. Counsel is to refer docketed cases to Appeals for settlement unless the statutory notice of deficiency was issued by Appeals, the IRS Employee Plans/Exempt Organizations function (now part of the IRS Tax Exempt and Government Entities Division (TE/GE)), or by a District Director based on a National Office ruling or technical advise in that case involving employee plan qualification or tax exemption and/or an organization's foundation status. Counsel also does not refer cases to Appeals that are docketed under IRC sections 6110, 7428, 1476, 7477 or 7478. Appeals is to return cases for $10,000 or less fifteen days before the trial calendar call and return cases over $10,000 "promptly" after a case appears on the trial calendar. *Id.*

[33] *See* Table 1.7.2 above. The majority of campus generated docketed S case work will be centralized in Fresno, thus, the specific docketed S case procedures are targeted to Appeals' Fresno campus operations.

[34] *See* memorandum Appeals Area Directors, April 13, 2005, from Appeals Director, Field Operations-East and Appeals Director, Field Operations-West, *Appeals Continuing Commitment to Settle S-Docketed Cases Before Trial.*

[35] IRS Office of Appeals, Campus Implementation, Taxpayer Advocate Briefing (March 31, 2005).

[36] Appeals campus S case screeners are similar to Appeals Collection Specialists. Collection Specialists are Grade 11 employees who's duties include: (1) independently reviewing cases for issues such as statutes of limitation and initiating further contact with taxpayers and their representatives to resolve problems; (2) analyzing taxpayer responses and initiating further contact with taxpayers; (3) researching and analyzing information retrieved from automated and manual systems to verify issues relating to compliance history and other matters to resolve disputes between Compliance and the taxpayer; (4) advising management of problems and recommending solutions; (5) making financial determinations as to processibility of offers; (6) maintaining appropriate liaison professional contact with other divisions of IRS; and (7) acting as liaison for Appeals with the other Compliance functions to improve case processing. IRS Modernization Position Description, Appeals Account Resolution Specialist, MPD# 94146.

[37] E-mail from Director, Appeals, Area 8 to Director, Appeals Tax Policy and Procedure, September 29, 2005. For each AO, screeners are to schedule up to four conferences a day (preferably at least two hours apart) three days per week. Workload permitting, AO's are to keep this conference schedule for at least two weeks but no more than three weeks, per month. IRS Office of Appeals, *Timeline for Breakthrough S Cases* (June 18, 2004).

[38] IRS Office of Appeals, *Appeals Breakthrough Performance Plan, Small Docketed Cases* ("S" Cases) (June 18, 2004).

dures state that Screeners can close non-Grade 13 cases that involve individual taxpayer returns,[39] and that do not involve certain issues.[40] If a case does not meet all of these "Screener criteria," the Screener must send the case to a campus AO.[41] In certain cases received from a Screener, the AO is to use the adjustment schedule prepared by the Screener and not rework the case. The AO will hold the conference as scheduled in the initial contact letter; any follow up conference must be scheduled within 30 days of the first. The AO can grant *one* 30 day extension of time for the taxpayer to provide additional information without managerial approval – any additional time extensions must be approved by the ATM.[42] Because campus Appeals works only Grade 12 cases or lower, generally all campus assigned docketed S cases will initially be routed to a Screener.[43]

It is our understanding from verbal conversations with Appeals management that the campus Screeners' primary responsibility is determining initial case processing. Screeners review only GS-11 cases (GS-12 and GS-13 cases go directly to AOs), and have authority to resolve cases that do not involve the exercise of discretion. According to Appeals' management, campus Screeners can close cases involving (1) no change decision documents; (2) simple cases involving only one issue; and (3) cases where the taxpayer has not responded to two Appeals contact letters and one Appeals phone call (no response cases).[44] This explanation of the Screener's duties and responsibilities is not entirely consistent with the Appeals written campus docketed S case procedures and may lead to disparate treatment of taxpayers.

Face-to-Face and Local Office Hearings

Some taxpayers may prefer to deal with Appeals on a face-to-face basis or with an AO that is familiar with local circumstances. Thus, these taxpayers may request that their cases be transferred to a field office near the taxpayers. Appeals has stated publicly that these requests will be granted.[45] However, there appears to be some uncertainty concerning case transfers from campuses to local offices. Appeals' Breakthrough S Case procedures explain that when a taxpayer requests that his or her case be transferred to a local Appeals office, the screener will refer the request to the ATM for evaluation. If the

[39] Generally filed on the Form 1040 Series.

[40] IRS Office of *Appeals, Appeals Breakthrough Performance Plan, Small Docketed Cases* ("S" Cases) (June 18, 2004). Screeners must forward cases to an AO that involve spousal defense, unreported income using indirect methods, IRC § 183 (activities not engaged in for profit), TEFRA, or abusive trusts. Additionally, an ATM may assign certain non-Grade 13 cases involving "sufficiently complex" issues directly to an AO, bypassing the Screener. *Id.*

[41] IRS Office of Appeals, *Appeals Breakthrough Performance Plan, Small Docketed Cases* ("S" Cases) (June 18, 2004).

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] Treasury Inspector General for Tax Administration Ref. No. 2005-10-141, *The Overall Independence of the Office of Appeals Appears to be Sufficient* (Sept. 2005); *see also* IRS Office of Appeals, Campus Implementation, Taxpayer Advocate Briefing (March 31, 2005).

ATM determines that the request will be granted, the Screener will prepare the administrative file for transfer or reassignment. Additionally, the S case initial contact letter is not particularly clear about a taxpayer's face-to-face or transfer options. The initial contact letter mentions face-to-face conferences, but does not specifically state that these conferences will be granted upon request. The letter states,

> We have found that most taxpayers prefer to have an Appeals conference by telephone or correspondence. Since the time period for Appeals to work your case is very limited, we have planned a phone conference for the time and date shown above. **Before** that date, please call the number listed above to:
>
> - discuss whether a face-to-face conference at the Appeals office closest to your residence/business might be better for you. Face-to-face conferences are more appropriate for cases involving complex issues or a substantial volume of documentation.[46]

Both the Breakthrough S Case procedures and the initial contact letter suggest that Appeals will not automatically grant taxpayer requests for transfers to the field. It appears that a taxpayer desiring a case transfer for a face-to-face conference must first "discuss whether a face-to-face conference [at the local Appeals office] might be better for you" than a telephone or correspondence conference. It is not clear with whom the taxpayer will have this "discussion." There is also no assurance that a taxpayer's specific request for a face-to-face conference will be granted. To the contrary, the Breakthrough S case procedures indicate that case transfer and face-to-face conference requests must be approved by an ATM.

CONCERNS WITH CAMPUS CENTRALIZATION

There is nothing inherently wrong with Appeals working certain cases at IRS campuses. The IRS has been conducting various activities at its campuses (formerly known as service centers) for many years. In fact, the Taxpayer Advocate Service (TAS) has offices in each campus that handle taxpayer problems and work taxpayer cases. Appeals campus centralization, however, is driven largely by Appeals' desire to streamline its inventory and reduce case cycle time.[47] While shortening Appeals' case cycle time is a worthy objective, an Appeals-wide campus centralization policy that is driven by the goal of improving cycle time numbers may ultimately have a negative impact on taxpayer burden and taxpayer rights. Inventory management goals must be balanced with training and procedures that ensure that the rights and interests of all taxpayers – particularly those of lower income and without representation – are protected.

TAS is concerned that Campus Appeals is replacing many of the services Appeals traditionally offered in the field. Appeals experienced both a significant decrease in

46 Letter 3808(CG) *(S-Docketed Initial Contact Letter)* (Rev. 8-2005) (emphasis in original).

47 Appeals Strategy and Program Plan, FY 2005/2009; Videotape: *January 2005 Video on APS by Phil Mahler* (on file with IRS Office of Appeals).

field employees and a significant increase in campus employees in FY 2005.[48] While the FY 2005 staffing numbers alone do not definitively establish that Appeals campus hires directly replaced field attrition, they do demonstrate that Appeals' field presence is shrinking at the same time its campus presence is growing, and that the number of highly skilled Appeals officers in the field is declining overall. This workforce shift has the potential to negatively impact taxpayer rights if Campus Appeals fails to provide the same quality taxpayer services that have been traditionally found in Appeals field offices.

In the paragraphs below, we discuss our specific concerns with Appeals campus centralization. We realize that some of these concerns may be considered "prospective" because Appeals campus centralization is fairly new. However, surfacing even "prospective" concerns now will allow Appeals to develop and implement remedies to existing problems, as well as procedures designed to prevent problems in the future.

Campus Screeners

A primary concern with Appeals campus centralization is the role of the campus Screeners. According to Appeals written campus docketed S case procedures, all campus Appeals cases will initially be routed to a Screener. Depending on the case grade level and the issues in the case, the Screeners will then forward certain cases to AOs and resolve certain cases themselves. The written procedures also state that when an AO receives certain non grade 13 cases from a Screener, the AO is to use the adjustment schedule prepared by the Screener and not rework the case.[49]

If Appeals' written campus docketed S case procedures are correct, TAS is concerned that Appeals may be using GS-9 Screeners as substitute AOs in the campus setting, or even to "screen out" an AO's discretion in certain cases. There is no indication that campus Screeners are receiving the training or oversight necessary to perform discretionary duties.

We understand that Appeals' management does not intend for campus Screeners to function in a discretionary capacity. According to verbal conversations with Appeals management, Screeners can only close cases in very limited circumstances. The Screeners' primary roles are case intake processing and appointment scheduling. TAS urges Appeals to reconcile its written procedures with management's intent. Campus employees are typically not privy to management's intent on a day to day basis. These employees, however, do have ready access to written procedures and will follow these procedures when questions arise. TAS believes it is imperative that campus Screeners responsibilities be limited to processing and appointment setting functions in order to provide taxpayers with a meaningful and independent administrative appeal.

48 *See* Table 1.7.4, Appeals Campus Staffing FY-2005, and Table 1.7.5, Appeals Field Staffing FY-2005.

49 IRS Office of Appeals, *Appeals Breakthrough Performance Plan Small Docketed Cases ("S" Cases)*, June 18, 2004.

Lost Face-to-Face and Local Office Opportunities

Another significant concern with Appeals campus centralization is the effect it will have on the taxpayer's opportunity to have a face-to-face Appeals conference, or to have his or her case assigned to a local AO. When a taxpayer's case is worked in a campus rather than a local Appeals office, it is almost certain that the case will be worked outside of the taxpayer's geographic area – perhaps thousands of miles away. Thus, if a taxpayer desires to meet personally with an Appeals employee, Appeals will have to transfer the case to a field office near the taxpayer.

Appeals has stated both publicly and internally that taxpayers requesting a face-to-face conference will receive one. When a taxpayer requests a face-to-face Appeals conference, Appeals is to transfer the taxpayer's case to the field office nearest the taxpayer. There appears to be some uncertainty, however, about Appeals' case transfer policy.

As an initial matter, when Appeals officials have addressed the face-to-face issue with respect to campus centralization, they generally also explain that "most people don't want a face-to-face interview."[50] Appeals supports this assertion by citing the low percentage of taxpayers who have had face-to-face conferences in recent years (14 percent from April 1, 2004 to March 31, 2005).[51] Appeals does not explain, however, how many of these taxpayers specifically declined the opportunity for a face-to-face conference versus how many did not request one at all. In other words, Appeals knows the population of taxpayers who did not have face-to-face conferences, but it does not appear to know *why* these taxpayers failed to utilize a face-to-face opportunity. How many of these taxpayers did not request a face-to-face conference because they did not know it was an option? And how many taxpayers requested a face-to-face conference but did not receive one? Appeals does not currently capture any of this information.

Additionally, Appeals fails to differentiate face-to-face meetings from a taxpayer's need to have a *local* conference. Some taxpayers may not want or need a face-to-face conference, and may even find such a hearing burdensome. But in many cases, taxpayers do need a local AO who understands the particular environment or occupation of the taxpayer. One example is a taxpayer requesting a penalty abatement in a payroll agent fraud case.[52] It would be much more beneficial to this taxpayer to have his or her case assigned to a local AO who is familiar with the payroll agent case through local press

50 Allen Kenney, *IRS Appeals Chief Claims Independence, 2005* TNT 98-5 (May 20, 2005); *see* Treasury Inspector General for Tax Administration Ref. No. 2005-10-141, *The Overall Independence of the Office of Appeals Appears to be Sufficient* (Sept. 2005); *see also* IRS Office of Appeals, Campus Implementation, Taxpayer Advocate Briefing (March 31, 2005).

51 Appeals Centralized Database System-CASES and CARATS Report (April 29, 2005).

52 In these cases, a small business taxpayer contracts with a payroll agent to collect and deposit payroll taxes with the IRS. The payroll agent collects the taxes from the small business, but does not deposit the taxes with the IRS. The small business owner is then left with tax liability, interest and penalties for taxes already turned over to the payroll agent. For a more in depth discussion of this issue, *see* National Taxpayer Advocate 2004 Annual Report to Congress, 394-398 (Protection from Payroll Service Provider Misappropriation).

coverage and who understands specifically how the case is affecting local small business taxpayers. Another example is a taxpayer who claims the Earned Income Tax Credit (EITC) and whose income is based on tobacco sales and subsidies in Virginia or North Carolina. A local AO would be much better equipped with the background information necessary to resolve these issues than would a campus AO in Fresno. Appeals' written guidance, however, does not address transfers based on local or regional issues.

There also appears to be some uncertainty about how the campus face-to-face/local transfer requests are actually working. Appeals' campus docketed S case transfer procedures seem to conflict. One set of procedures states that face-to-face/local transfer requests will be granted and no contingencies are mentioned.[53] Another set of procedures, however, states that face-to-face/local transfer requests must be approved by an ATM.[54] Additionally, the docketed S case initial contact letter is not entirely clear about whether Appeals will grant face-to-face conference or case transfer requests. And if Appeals will not automatically grant these requests, the criteria for granting or denying these requests are not set forth.

TAS believes that Appeals must immediately clarify these procedures to avoid both taxpayer and IRS confusion. Appeals campus employees will be familiar with procedures, but they may not be aware of senior Appeals officials' public statements. These employees may not know that the Chief of Appeals has assured practitioners that campus Appeals will routinely grant face-to-face/local transfer requests. If procedures tell campus employees to do something different, they will follow procedures. Additionally, it does not appear that any version of Appeals campus procedures is publicly available to taxpayers. Until correct campus procedures are included in the IRM – or at least available on the IRS web site – taxpayers and practitioners must rely on Appeals' public statements only. If procedures conflict with public perception, taxpayers and practitioners will lose confidence in Appeals.

Anecdotal evidence suggests that Appeals may not be granting face-to-face/local transfer requests without a fair amount of effort on the taxpayers' or representatives' part. Some practitioners have related less than positive experiences with campus transfer requests. One practitioner explained that he asked Appeals to transfer an OIC case from a campus to a local field office, only to be told that his case was not a good candidate for a face-to-face conference and it should stay in the campus.[55] At least two other practitioners came to TAS because they had specifically requested a face-to-face conference and a transfer to their respective taxpayers' local offices, but were told that their cases were part of a "project" and therefore face-to-face conferences and transfers would be granted only at Appeals' discretion. Another practitioner explained that her client did not have a face-to-face conference because Appeals did not inform the taxpayer that a face-to-face

[53] Campus Appeals – Field Counsel Fresno "S" Case Procedures, Aug. 12, 2004.

[54] IRS Office of Appeals, *Appeals Breakthrough Performance Plan Small Docketed Cases ("S" Cases)*, June 18, 2004.

[55] Appeals eventually granted the transfer request in this case.

conference was an option. This particular taxpayer was less educated, sophisticated, or articulate than many taxpayers – factors which led the practitioner to believe that the taxpayer would have benefited greatly from a face-to-face meeting with the AO. According to the representative, this taxpayer received an unfavorable result from a phone conference because the AO misunderstood several key facts that would have been easier to flesh out in a face-to-face conference. In a face-to-face setting, the AO would have had a first hand, in-person look at the taxpayer's supporting documentation, which clearly laid out the relevant facts. More importantly, the AO also would have been able to actually see the taxpayer and determine that she was having trouble communicating. A more meaningful conversation could have taken place that would have better facilitated communication and drawn out relevant facts. Instead, the representative had to subsequently rework the case through both TAS and Appeals to ensure that Appeals was aware of and considered all relevant facts.

TAS does not believe that local face-to-face Appeals conferences are necessary in all cases. In fact, TAS agrees with Appeals that in many instances the case may be best resolved via telephone conference, or, in rare instances, solely through correspondence. We are concerned, however, that Appeals campus centralization will result in lost face-to-face and local office opportunities for taxpayers who would be best served by in-person conferences or working with a local AO. We encourage Appeals to make good on its promise to grant local face-to-face conferences when taxpayers ask for them. We also urge Appeals to immediately clarify its face-to-face and case transfer procedures and clarify its initial contact letter to ensure that (1) taxpayers receive a local face-to-face conference when requested; (2) taxpayers know that they can request such a conference when desired; and (3) Appeals procedures address the need for local office transfers based on geographic specific issues – even when a face-to-face conference may not specifically be necessary.

DIMINISHED WORKING RELATIONSHIPS

In addition to lost face-to-face and local case assignment opportunities, TAS is concerned that Appeals campus centralization will also result in diminished personal working relationships between Appeals employees and taxpayers and their representatives. When Appeals works a case in the field, the Appeals employee working the case is typically located within a reasonable distance from the taxpayer or the taxpayer's representative. Geographic proximity facilitates an efficient and collaborative working relationship between the taxpayer and Appeals during the Appeals process. It is easier to exchange documents. If the taxpayer desires a face-to-face conference, one can be conveniently scheduled without transferring the case. A continuing telephone dialogue can be established. Local Appeals personnel are likely better equipped to handle any geographic specific issues. And, perhaps most importantly, the Appeals employee and taxpayer (and/or taxpayer's representative) can quickly address issues that arise as the case progresses by the most efficient and effective means available: documents can be hand delivered, the Appeals officer, taxpayer, or representative can be quickly contacted by telephone, and face-to-face meetings can be scheduled as necessary.

These efficient working relationships will be more difficult, if not impossible, to establish in a campus Appeals environment. Documents will have to be delivered long distance, with added time and expense for the taxpayer. In fact, it is our understanding that not all campus Appeals offices currently have toll-free fax numbers; thus, if a taxpayer needs to quickly deliver a document, he or she will have to incur overnight mail or long-distance phone charges. Low income taxpayers may not be able to afford to send documents by either method. Taxpayers can, of course, contact campus Appeals by telephone, but it is not clear if taxpayers will have a direct line to an Appeals employee or if they will have to navigate an automated phone system to reach the person working their case. Time zone differences may also complicate phone communications as business hours at the campus may be different from where the taxpayer lives. We also understand that some campus Appeals offices have not yet set up toll-free phone lines, forcing taxpayers to incur long-distance charges in order to speak with Appeals about their case. And most burdensome, when issues arise during the Appeals process that would best be discussed on a face-to-face basis, the taxpayer's case must be transferred to a local office mid-stream, if it is transferred at all. This scenario will lengthen the Appeals process, burdening both the taxpayer and Appeals.

THE IRS CAMPUS

The IRS campus culture has traditionally been production oriented with limited employee discretion and decision-making. Generally, campus procedures do not easily lend themselves to the facts and circumstances analyses that are essential in resolving cases in Appeals. Furthermore, since many Appeals cases now originate in IRS campus enforcement, taxpayers may not believe that their case will receive a truly independent review from Campus Appeals. These taxpayers may not communicate or respond to Campus Appeals under the mistaken belief that Campus Appeals and campus enforcement are not separate.

TAS does not believe that Appeals campus operations are impossible, or that Appeals should not operate in IRS campuses. To the contrary, TAS operates successfully at each IRS campus using employees that once worked in campus taxpayer service and enforcement functions. We do believe, however, that training campus employees to successfully transition from processing and production to independent thinking and discretionary judgment requires a concentrated effort and focused strategy. At this time, however, Appeals does not provide campus specific training for its campus employees. TAS encourages Appeals to develop campus specific training to help its employees effectively operate in the IRS campus environment.

We are also concerned that Appeals campus centralization may fall victim to the problems that have plagued other IRS campus centralization efforts. The IRS has moved to campus centralization in several areas in addition to Appeals. The IRS processes "simple" Offers in Compromise at the Brookhaven and Memphis campuses; Innocent Spouse cases at the Covington (Cincinnati) campus, and EITC audits are virtually entirely conducted at campuses. Practitioner reviews of campus centralization have not been favorable. One Low Income Taxpayer Clinic director offered this critique of centralized EITC audits being conducted through IRS campuses via correspondence:

> [These] audits for the most part are based on notices that are computer generated. … In the notices, the IRS requests that the taxpayer's information and supporting documents be mailed to the campus officer working the case. When a taxpayer responds to the notice by submitting records and other information there is (based on our anecdotal experience and the experiences of other clinics) very little reaching out to or attempting to contact taxpayers who send in partial responses to requests for information, or to those who send in information that is not in the precise form requested by the agency. The emphasis is on rapid case processing with minimum resources expended – and reduced discretion of IRS employees to accept alternative forms of proof [for claimed EITC credits] – to produce uniform results. That often translates into the prompt issuance of a deficiency notice shortly after the filing of a return, sometimes as quickly as within six to eight months (or less) of the filing date. The taxpayer is then required to file a petition in the Tax Court to engage in a dialogue with anyone in an effort to resolve the issue.
>
> We have recently seen several taxpayers who were told by the IRS early in the administrative process that if they didn't have the exact papers requested, "just wait for a 90-day letter, go to Tax Court, and talk to IRS Area Counsel." Not only is that inefficient, but it also exacts a Tax Court filing fee as a toll charge to speak to the IRS. It also may prolong the receipt of a claimed refund by many months or more.[56]

Practitioners give the IRS centralized Offer-in-Compromise program similar reviews. In 2003, the American Institute of Certified Public Accountants (AICPA) surveyed its members about the OIC program. The survey results were not favorable to the campus OIC (COIC) program:

> Based on the concerns expressed by many of our members, we do fear that the IRS employees at the COIC sites might by 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.
>
> This concern is borne out by the responses to Question 6 – "Are IRS employees adequately trained to understand issues relating to the OIC program?" The respondents who believe training is inadequate emphasized their impression that OIC 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

[56] Janet Spragens and Nancy Abramowitz, *Low Income Taxpayers and the Modernized IRS: A View from the Trenches*, 107 Tax Notes 1407 (June 13, 2005) (quote includes text of footnote 20).

the Offer as opposed to finding reasons to accept it.[57]

Common themes in the practitioners' campus centralization criticisms include: lack of personal contact with taxpayers; basing decisions on "standards" rather than considering the taxpayer's individual facts and circumstances; emphasizing rapid case processing; and a lack of independent discretion and decision making. It is premature to attribute these problems to Appeals campus centralization because the program is fairly new. TAS is concerned, however, that the problems expressed by these practitioners will also befall campus Appeals unless Appeals directs significant, immediate, and continuing efforts toward training, support, and oversight of its campus employees.

CONCERNS FOR LOW INCOME TAXPAYERS

TAS is particularly concerned with the effects of Appeals campus centralization on low income and unrepresented taxpayers. "Low income taxpayer" is not synonymous with "simple return." Many low income taxpayers are small business owners who must file quarterly tax estimates, pay self-employment taxes and file Schedule C.[58] Many low income taxpayers also claim the Earned Income Tax Credit (EITC). The Treasury Inspector General for Tax Administration called the EITC a "program that is so complicated it is difficult for both taxpayers and the IRS to consistently and accurately determine eligibility."[59] The EITC provisions contain 2,680 words and require at least a twelfth-grade education to understand; the EITC information package (IRS Publication 596) contains 53 pages of forms, instructions and worksheets; and in tax year 2003, more than 70 percent of EITC claimants used a paid preparer.[60] In addition to the EITC, many low income

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[57] Robert A. Zarzar, *AICPA Submits Survey Results on Offer-in-Compromise Program*, 2003 T.N.T. 200-38 (Oct. 16, 2003). The survey also reflected the "nearly unanimous opinion … that the IRS intentionally looks for reasons to reject an OIC." *Id.* The American Bar Association expressed similar concerns about the COIC program:

> The centralized processing system was designed to reduce the backlog created by the increasing number of offers in compromise submitted each year. Unfortunately, in some cases, the backlog is being reduced simply by the return of offer packets that have only minor omissions in documentation. Failure by the taxpayer to provide the missing documentation in a short time-frame results in the offer not being processed at all. This strict "gatekeeper" approach is not consistent with recent Congressional efforts to liberalize the OIC program and encourage reasonable collection alternatives. Similarly, many IRS employees … who process offers in compromise refuse . . . to consider individual facts and circumstances when applying allowable expense standards for offers in compromise.

Robert E. McKenzie, Statement of Robert McKenzie on behalf of the American Bar Association Section of Taxation, Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means, *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=274 (Apr. 8, 2003).

[58] Janet Spragens and Nancy Abramowitz, *Low Income Taxpayers and the IRS: A View From the Trenches*, 107 Tax Notes 1407 (June 13, 2005).

[59] J. Russell George, Treasury Inspector General for Tax Administration, Testimony Before the Senate Committee on Finance, *available at* http://finance.senate.gov/hearings/testimony/2005test/rgtest041405.pdf (April 14, 2005); *see also* IRS Announces Steps to Improve EITC Administration, Seeks Public Comment (June 13, 2003) (IRS Commissioner Mark Everson noted that EITC audits are too time consuming and burdensome for taxpayers).

[60] Nina E. Olson, National Taxpayer Advocate, Bestimony before the President's Advisory Panel on Federal Tax Reform, *available at* http://www.taxreformpanel.gov/meetings/docs/olson_03032005.ppt (March 3, 2005).

taxpayer returns also contain issues with the child tax credit, the dependent care credit, education credits, head of household filing status, income from disability pensions, in-kind charitable contributions, premature IRA distributions, and gambling losses.[61]

In addition to these complex tax return issues, low income taxpayers possess several characteristics that pose significant communication challenges. For instance, many low income taxpayers have limited English proficiency or have literacy problems. These taxpayers also tend not to keep good records and have limited or no access to computers, the internet, or even copiers and fax machines.[62] Low income taxpayers also typically cannot afford tax representation; and when they can, the competency of that representation is suspect.[63]

We are concerned that Appeals' centralization objective of "getting the right work to the right employee" is based on faulty assumptions concerning low income taxpayers. "Getting the right work to the right employee means matching case work to the skills and grade level of the individual employee."[64] On its face, this is a legitimate goal. When employees are either over-tasked or under-utilized efficiency suffers. TAS is concerned, however, that Appeals right work/right employee strategy does not accurately account for the complexity of some low income taxpayer cases.

Appeals believes that its campus cases are "relatively straightforward, limited issue cases" that lend themselves to a "resolution through a telephone conference or by looking at a few pieces of documentation submitted by correspondence."[65] However, many of Appeals' centralized workstreams involve low income taxpayers whose cases do not fit the "relatively straightforward/limited issue" mold. For example, a self-employed low income taxpayer with limited English and literacy proficiency claims the EITC. Numerous complex issues could arise in an audit of this taxpayer that would be later considered by Appeals. If Appeals assigns this taxpayer's case to a campus, additional problems would likely ensue. The case will be worked by a GS-12 employee (or lower). The taxpayer will receive a letter, in English, containing a pre-scheduled telephone conference date and time and requesting additional documentation. If the taxpayer understands the letter well enough to respond, he will likely have limited ability to copy the applicable documents and get them to the appropriate Appeals person and to call in for his conference at the pre-scheduled time. If he can call in, he will most likely have

61 Janet Spragens and Nancy Abramowitz, *Low Income Taxpayers and the IRS: A View From the Trenches,* 107 Tax Notes 1407 (June 13, 2005).

62 *Id.; See also* Leslie Book, CDP and Collections: Perceptions and Misperceptions, 107 Tax Notes 487 (March 31, 2005).

63 *See* National Taxpayer Advocate, 2004 Annual Report to Congress, 67-88; Janet Spragens and Nancy Abramowitz, *Low Income Taxpayers and the IRS: A View From the Trenches*, 107 Tax Notes 1407 (June 13, 2005).

64 Appeals Strategic Plan 2005-2006.

65 David B. Robision, IRS Appeals: Service Improvements Via a Campus Strategy Approach, E.A. Journal (Sept.-Oct. 2005) at 21.

difficulty navigating the campus phone system and communicating with the AO. If, on the other hand, this taxpayer does not understand the letter, he will lose his Appeal rights. In short, Appeals campus centralization will provide taxpayers in the low income demographic limited, if any, Appeal rights.

IRS COMMENTS

In general, the IRS disagrees that the Appeals Campus Centralization issue described by the National Taxpayer Advocate should be considered a most serious problem for taxpayers as they interface with the IRS. Her stated premise is the Appeals strategy has a "…potential to negatively impact taxpayers." This MSP statement is a hypothesis supported with little objective data. However, the IRS does appreciate the underlying concern the National Taxpayer Advocate expresses – the need for a strong, independent and technically excellent Appeals staff. Taxpayers need and demand this, and the IRS has been, and continues to be, committed to providing taxpayers with just such an Appeals function.

Appeals Goals

The creation of campus operations has been part of the Appeals strategy since Appeals submitted its 2003-2004 Strategic Plan to the Commissioner in September 2002. It has been part of every strategic plan since then. It's a strategy driven by Appeals' goal to address customer satisfaction issues and reduce taxpayer burden. It's a strategy based on maintaining high decision quality.

Taxpayers said they are concerned about the length of the Appeals process, the time it takes to make the first contact and the time it takes to schedule a conference. The campus operations are part of the breakthrough and reengineering initiatives developed to address taxpayer concerns about the length of the Appeals process. The campus operations are being monitored to ensure the efficiencies realized are not at the expense of quality and customer satisfaction.

Appeals' goal is to provide excellent customer service and high quality case resolution. Cycle time is only one aspect of that measure. Appeals will continue to use a balanced measures approach to evaluate its campus strategy, and if those measures support a need to modify their strategy they will do so.

FY 2005 found Appeals in its final implementation phase of campus operations. The hiring and training is now complete and campus operations will be entering into full operations this year. Appeals expects changes in planning and procedures throughout the year, and will consider the issues the National Taxpayer Advocate has suggested as they modify their campus operations.

Balanced measures data is available showing the effectiveness of the campus operations. While the campus operations are relatively new, the data reflects favorably on them. The IRS believes the following data clearly indicates the Appeals campus employees are able to deliver the same quality service to taxpayers as the Appeals field employees.

Customer Satisfaction Measure – Survey Results:

FY 2005 full-year results haven't been received from the vendor. These are FY 2004 results:

TABLE 1.7.6

Question	Campus Score	Appeals Overal Score
Explanation of Your Rights	3.82	3.72
Clarity of Records and Documents Needed	3.91	3.70
Application of Law to Facts in Your Case	3.72	3.44
Fairness in Resolving Your Case	3.60	3.47
Professionalism of Appeals Person	4.29	4.14
Time to Hear from Appeals	3.04	3.00
Time to Schedule Your Initial Conference	3.74	3.45
Independence of Appeals (see below)	3.99	3.69

Independence

The National Taxpayer Advocate expresses a concern that "since many Appeals cases now originate in IRS campus enforcement, taxpayers may not believe that their case will receive a truly independent review from Campus Appeals." The Appeals customer satisfaction survey results do not support a finding that Appeals independence is negatively impacted by being co-located with IRS campuses. The customer satisfaction data for Appeals campus operations indicate taxpayers who had their Appeals case decided in a campus setting rated Appeals independence higher (3.99) than the overall Appeals score for independence (3.69).

Business Measure - Quality (AQMS) Results:

(Period covered 10/1/04 thru 6/30/05–Score out of a possible 100)

TABLE 1.7.7

	Score
Appeals Overall Quality Score	81
Range of Scores for Field Operations	74 – 86
Range of Scores for Campus Operations	80 – 94

Business Measure – Quality (Cycle Time) Results:

(Cycle time is number of days from the date the case is received in Appeals until the date closed.)

TABLE 1.7.8

	FY04	FY05
Cycle Time Consolidated	261 days	258 days
Campus Cycle Time	134 days	135 days

Appeals Staffing

Appeals has completed its major transition of staffing between campus and field operations. Depending on budgetary limitations the plans are to allow attrition hiring in both campus and field operations.

The redeployment of staffing between campus and field was a carefully devised plan that began to take shape in Appeals in 2002. In September 2002, it was formally introduced in the Appeals 2003-2004 Strategic Plan. This redeployment of staffing did not come at a detriment to the field. The transition was accompanied by a corresponding shift of inventory to the campuses. The campus operations provide for the matching of case work to the skills and grade level of the individual employees. The result has been an overall balancing of inventories and is enabling Appeals to provide more efficient and effective service to all taxpayers.

Appeals Procedures

The IRS would like to correct a few misapprehensions given in the National Taxpayer Advocate's statement regarding procedural issues.

S Docketed Procedures:

The National Taxpayer Advocate states "Appeals returns docketed S cases to Counsel when a case appears on the Tax Court trial calendar." Once a case appears on a trial calendar, Appeals has always retained docketed cases for settlement if Counsel and Appeals agree it's appropriate for a particular case. The campus S docketed procedures generally call for retention of the case file for settlement until three weeks prior to the trial calendar. If Appeals has been unsuccessful in their attempts to contact the taxpayer, the case will be forwarded to Counsel for trial preparation. Appeals campus operations like field operations make multiple attempts–both by letter and by phone–to reach taxpayers to discuss settlement. If after these attempts Appeals has not been able to resolve the case, it will transfer the case to Counsel for trial preparation. In the event taxpayers wish to initiate settlement discussions immediately prior to the calendar, local Appeals field offices will attempt to resolve these cases. Generally, these cases are not in the midst of settlement negotiations when they are forwarded to Counsel as the National Taxpayer Advocate believes. The IRS believes that these procedures more than adequately ensure taxpayers can enter into settlement discussions if they wish.

Use of "screeners:"

The National Taxpayer Advocate states, "According to Appeals Campus Docketed S case written procedures, screeners can also resolve certain cases on their own without sending the case to an AO." These case screeners do not enter into settlement negotiations with taxpayers–they schedule appointments, request documentation from taxpayers, and refer cases for trial preparation if a taxpayer doesn't contact Appeals. These are administrative tasks; they are not case "settlement" tasks.

The Appeals Campus Docketed S Case procedures are very specific in the description of screener duties and responsibilities and in the description of screener case criteria. The procedures do not provide for the screener to do any evaluations of information for case settlement purposes, no matter what the issue is or how many issues there are. There is nothing in the written procedures that suggests that the screeners may be used as substitute AO's in a campus. The Campus Appeals Team Managers are following the written procedures for screeners and are not utilizing screeners to perform the duties of an AO.

The National Taxpayer Advocate discusses three examples of conflict between Appeals management's explanation of screener duties and the written procedures. The first example cited is that screeners can close cases involving no-change decision documents. This is not an exercise of discretion; these cases are reviewed by the manager before closing. The written procedures specifically provide that the no-change letter is to be from the source of the case and is to be dated after the issuance of the notice of deficiency. If these are the circumstances, the screener will prepare no-change decision documents or forward the case to Counsel for preparation of decision documents. This is an administrative task, not a "decision-making" one. Another example cited by the National Taxpayer Advocate has to do with screeners closing no show or no response cases. Again, the screener is not closing these cases. These cases are reassigned or returned to a screener after an AO makes the determination that the case is a no show or no response. This is specifically explained in the written procedures. Furthermore, all docketed S cases are reviewed and approved by a manager before closing.

Finally, while the docketed S case screeners serve as aides to the appeals officers and aren't used for decision making, the job series (GS-526) for this position is a technical one. This position can serve as a training position for promotional opportunities to the appeals officer position.

Face to Face Conferences

There is no lost face-to-face opportunity. The right to a face-to-face conference is clearly explained in the initial contact letter. It states that the taxpayer can call and discuss whether a face-to-face conference might be better. The National Taxpayer Advocate reports there is some uncertainty concerning case transfers from campuses to local offices. The report supports the finding of uncertainty by citing the written procedures that state the screener will refer the request to the ATM for approval if the taxpayer asks for a transfer to a local Appeals office. This procedure is an example of the use of screeners for administrative duties and not decision making. This doesn't raise doubt about the allowance of transfers to local offices for face-to-face conferences. Management evaluation of the request is required to ensure the taxpayer is not raising issues such as the constitutionality of the tax system or using the request as part of a scheme to avoid or delay the resolution of the case. It would be inappropriate to state in the letter that the taxpayer need only ask for a transfer to a local office and it will be granted. This would provide an avenue to taxpayers who only want to delay. It is appropriate to state, as the letter does, that the taxpayer may make the request. Appeals has demonstrated not only by its words but by its actions that requests for a face-to-face conference are being granted.

Regarding Appeals face-to-face conferencing practices, current data indicates for cases considered in Appeals field operations the following:

TABLE 1.7.9

	Number of Conferenced Field Closures	% of Conferenced Field Closures
Total Closures with conferences	48,296*	67%*
Face-to-Face Conferencing	15,414	22%
Phone Conferencing	32,882	46%

**The balance of field closures were either closed by correspondence or a conference was not required.*

The cases considered in Appeals field operations are generally more complex factually and have multiple issues. Also, they generally require presentation of documentation too voluminous to present by mail or review over the phone. Even with that, only 22 percent of the total field closures were resolved using face-to-face techniques.

Appeals recognizes that the National Taxpayer Advocate's objective with her report is to ensure taxpayers are provided quality Appeals case resolution services. Appeals' goal is to provide timely quality service by having a strong technically trained Appeals staff in all locations – campus and field. Appeals is gratified one of the teams in its initial campus operation – Brookhaven – is a 2005 Commissioner's Award recipient. The Brookhaven team was formed in March 2004 and "…quickly became a model of success" for all the campus operations. The IRS believes this is a very strong indicator of Appeals' commitment to its stated goals.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate has identified Appeals Campus Centralization because of its potential to impair the quality of Appeals' review. As with our discussion of the IRS's Private Debt Collection initiative herein, we have attempted to identify potential problems that, if not addressed and monitored, could harm taxpayers and undermine tax administration. To this end, we raised specific concerns about Appeals' centralization initiative. In its response, Appeals describes its efforts to address these concerns.

We believe this transparency increases taxpayers' confidence in an independent Appeals function.

TAS remains concerned, however, about the adequacy of Appeals' staffing levels in the field and training in the campuses, and the access of taxpayers to local hearings. Appeals has also not addressed the needs of low income taxpayers, who may particularly benefit from local or face-to-face hearings.

In particular, the centralization of Appeals operations creates two classes of Appeals conferences and has the potential to deprive low income taxpayers of important taxpayer rights. Most of the work that Appeals categorizes as "noncomplex" is generated by campus operations – OIC, ACS, EITC correspondence examinations – which involve unrepresented low income and working poor taxpayers. TAS's EITC Audit Reconsideration Study demonstrated that in many of the cases in which taxpayers sought audit reconsideration from campus EITC correspondence audits, it was the campus procedures themselves that contributed to the IRS not getting the correct result the first time around.[66]

These taxpayers will now be seeking relief from an Appeals office that operates in the same environment as campus compliance functions. Even if Appeals were to take a different approach from traditional campus procedures – which it has not fully demonstrated that it is – Appeals cannot deny that some taxpayers, perhaps even a significant percentage of taxpayers, will view the Appeals conference as more of the same old IRS. As the IRS becomes more remote, it has to work harder to earn taxpayers' confidence that they are not just some cog in a machine.

Ultimately, only those taxpayers who are represented by savvy practitioners will obtain hearings in local offices. Unrepresented poor and middle income taxpayers will not know either that they can ask for such a hearing or how a hearing in a local office can benefit their cases. And even if taxpayers wanted such hearings, Appeals' staffing – including a significant decrease in Appeals Officers in the field – means that taxpayers would have to wait an extremely long time before they got that hearing. Appeals itself says that timeliness is extremely important to taxpayers. Thus, Appeals' procedures and Appeals' staffing decisions are stacked against taxpayers getting a local hearing, much less a face-to-face one. They are self-fulfilling prophecies.

Timeliness vs. Quality

We again emphasize that there is nothing inherently wrong with Appeals working certain cases at IRS campuses. In fact, we believe that Appeals' goal to reduce case cycle time through campus centralization is a worthy objective. The IRS response indicates that Appeals is meeting this objective as campus case cycle times appear to be more than 100 days shorter than overall Appeals case cycle times.

[66] National Taxpayer Advocate 2004 Annual Report to Congress vol II.

We are concerned, however, that if Appeals campus operations are not carefully monitored and measured for quality as well as quickness, the taxpayer burden of resolving a case through Appeals may ultimately increase. The National Taxpayer Advocate commends Appeals for recognizing the importance of quality as well as timely case resolution and committing to monitor campus operations "to ensure that the efficiencies realized are not at the expense of quality and customer satisfaction." We also appreciate Appeals' willingness to consider our recommendations as it continuities to develop campus planning and procedures and modify its campus operations throughout the coming year. In turn, the Taxpayer Advocate Service commits to assist Appeals in monitoring Appeals campus case quality and to quickly inform Appeals of any problems with campus centralization that taxpayers bring to our attention.

Appeals Campus Procedures

In its response, the IRS suggests we presented a misleading, if not incorrect, picture of Appeals campus procedures. Our presentation of these procedures was based primarily on four documents:

1. "Campus Appeals – Field Counsel 'S' Case Procedures," prepared by Appeals and dated August 12, 2004;
2. "Appeals Breakthrough Performance Plan Small Docketed Cases ("S" Cases)" (including a "Timeline for Breakthrough S Cases"), prepared by Appeals and dated June 18, 2004;
3. "Letter 3808(CG) *(S-Docketed Initial Contact Letter)*," revised by Appeals in August 2005; and
4. Rev. Proc. 87-24, 1987-1 C.B. 720, which sets forth the procedures for processing cases docketed in Tax Court.

Rev. Proc. 87-24 is available to the public, and the three Appeals documents were available on Appeals' IRS intranet web site. All of these documents were authored by Appeals or Chief Counsel and our explanations of Appeals campus procedures were taken directly from these documents or, in a very few cases, from written or oral correspondence from Appeals officials. Thus, any errors concerning Appeals campus procedures in our presentation are attributable to the inconsistency of the source materials.

We recognize that Appeals campus centralization is a new program that the respective procedures are continuing to be developed and refined. Appeals campus operations are up and running, however, and the National Taxpayer Advocate believes Appeals should quickly publish consistent and uniform campus procedures and make those procedures available publicly through the IRS website. Practitioners and taxpayers can rely on the Internal Revenue Manual to obtain guidance about general Appeals procedures, but they are currently in the dark with respect to Appeals campus procedures. Because taxpayers are currently in the Appeals campus system, Appeals should make publishing these procedures a priority.

Face-to-Face and Local Office Conferences

We agree with Appeals in that not every taxpayer needs to meet personally with an Appeals Officer to fairly resolve his or her case. On the contrary, many taxpayers may find it more efficient to resolve their cases over the phone (and perhaps in very rare instances solely through correspondence). Reduced face-to-face conferencing opportunities are only an ancillary piece of our overall concern with the shift towards campus Appeals: the loss of personal working relationships between taxpayers, practitioners, and local Appeals Officers. Local relationships with Appeals better serve taxpayers because local Appeals Officers are generally familiar with local issues and concerns; it is easy to deliver and distribute documents and correspondence; if a face-to-face conference is needed, one can be easily arranged without transferring the case; and relationships of trust between taxpayers, practitioners and the IRS can be developed, maintained and continued. These constructive characteristics of local relationships will be difficult to replicate in the campus environment.[67]

The National Taxpayer Advocate urges Appeals to continue to monitor its campus operations and implement appropriate measures to identify and correct taxpayer burden and fairness problems in the campuses. TAS will also continue to monitor Appeals campus operations for taxpayer problems and bring these to Appeals' attention so they can be addressed.

RECOMMENDATIONS

- Develop campus specific training for campus Appeals employees that will help them carry out Appeals' unique independent mission in the campus environment.
- Develop quality measures to monitor the impact of campus centralization on taxpayer Appeal rights and burdens.
- Work with TAS and the Low Income Taxpayer Clinics to identify low income taxpayer problems with campus centralization.
- Track requests for local office transfers and face-to-face conferences. Also, track both transfer requests granted and denied and the reasons for denial.
- Publish consistent and uniform campus Appeals procedures and make these procedures available publicly on the IRS website.
- Revise the Initial Contact Letter (Letter 3808(CG)) to clearly indicate that taxpayers have a *right* have their case transferred to a local office, provided that taxpayers make their transfer request as soon as possible, and that the request is not intended to unreasonably delay the Appeals process.

[67] Moreover, in S case litigation, transferring a case from the campus to the local counsel office, only to have it reopened by a local Appeals employee who is unfamiliar with the case and with the taxpayer, creates inefficiencies and could actually impede settlement.

PROBLEM TOPIC #8 MOST SERIOUS PROBLEM: REFUND ANTICIPATION LOANS: OVERSIGHT OF THE INDUSTRY, CROSS-COLLECTION TECHNIQUES, AND PAYMENT ALTERNATIVES

RESPONSIBLE OFFICIALS

Bert Dumars, Director, Electronic Tax Administration

Cono R. Namorato, Director, Office of Professional Responsibility

David R. Williams, Director, Earned Income Tax Credit Office

DEFINITION OF PROBLEM

The IRS contributes to the demand for Refund Anticipation Loans (RALs) by not offering an alternative method for taxpayers to obtain tax refunds quickly and at zero cost. Moreover, the IRS assists RAL providers by offering the Debt Indicator (DI). Although the DI program benefits taxpayers, the IRS needs to review its operation to properly balance competing tax administration concerns.

The IRS does not meaningfully review RAL marketing practices during e-file monitoring visits to Electronic Return Originators (EROs). This issue is of particular concern because many EROs have financial incentives to market RALs, and under IRS guidelines can own up to 49 percent of the RAL product. Further, the high rate of sanctions imposed during these visits indicates that the IRS needs to strengthen its oversight of EROs.

While RAL agreements may fully disclose the cross-collection practices of the banks that issue the loans, it is unclear whether RAL customers fully understand the ramifications of their consent to these practices. It is also questionable whether these provisions are enforceable under modern contract principles.

> **Example:** Taxpayer (T) goes to Tax Preparer (P) in February 2005 to prepare and file his 2004 federal income tax return. P prepares the return and determines that T is due a $3,000 refund. After P explains the various options available for filing and refund delivery, T chooses to purchase a RAL and signs all of the necessary disclosure and loan documents provided by the bank (B) associated with P. Once approved, T would receive loan proceeds of $2,780 – the $3,000 refund amount minus total fees of $220, which includes $120 for tax preparation, $75 for a bank finance charge and $25 for the bank account set-up fee.
>
> When the IRS receives T's return, it sends a Debt Indicator to P showing that T has no outstanding federal or certain other debts, and B releases the loan proceeds to T.
>
> While processing T's electronically filed return, the IRS finds a math error and does not pay the entire refund to B. B's collections department notifies T that he is bound by the terms of the RAL agreement and must repay the loan. Based on T's financial condition, T arranges to repay the loan over a period of two years, with a finance charge accruing at a rate of 1.5 percent per month.

In February 2006, T visits a different tax preparer, P2, to prepare his 2005 federal return and purchases another RAL from the bank (B2) associated with P2. After all the documents have been signed, B2 transmits to T only $2,000 of the expected $3,000 RAL proceeds, pursuant to the cross-collection provision in B2's standard loan agreement. B2 forwards the remaining $1,000 RAL proceeds to B.

ANALYSIS OF PROBLEM

Background

Description of RALs[1]

A refund anticipation loan (RAL) is a short-term loan based on the taxpayer's anticipated income tax refund. The taxpayer borrows against all or part of his or her expected refund and is responsible for paying the loan in full, no matter how much of the anticipated refund the IRS actually provides. Banks issue RALs, but commercial tax preparation businesses facilitate or broker the products. Before transferring any funds to the taxpayer, the bank first deducts fees for return preparation, filing, finance charges, and processing. The taxpayer receives the balance of the refund by check, direct deposit, debit card, or as a down payment on a good or service. Once the IRS issues the actual refund, the IRS transfers the funds directly to the bank to repay the loan.[2]

Demand for RALs

After increasing from tax years 1999 to 2001, the demand for RALs declined for tax year 2002 and rose slightly for tax year 2003.[3] As of the end of April 2005, the IRS received approximately 10.7 million RAL indicators on tax year 2004 individual income tax returns.[4] In contrast, the IRS received approximately 13.5 million RAL indicators for tax year 2002 individual returns. However, the 2002 and 2005 data are not necessarily comparable. The 2002 RAL indicator figure includes Refund Anticipation Checks

1 Additional bank products, including refund anticipation checks (RACs) and debit cards, are discussed in the following pages.

2 Alan Berube, Anne Kim, Benjamin Forman, and Megan Burns, *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC,* The Brookings Institution and The Progressive Policy Institute, 5 (May 2002); Gregory Elliehausen, Senior Research Scholar, Credit Research Center, McDonough School of Business, Georgetown University, *Consumer Use of Tax Refund Anticipation Loans,* Monograph No. 37, 1 (Apr. 2005).

3 The nationwide usage of RALs declined by approximately 4.3 percent between tax years 2001 and 2002, with a usage in tax year 2001 of 14.1 million and a usage of approximately 13.5 million in tax year 2002 (4.3 percent decline). RAL Indicators rose to 13.8 million in tax year 2003. The overall decline in RAL usage among Non-EITC taxpayers was approximately 7.9 percent during this period. In contrast, the percentage of decline among EITC taxpayers was only approximately 1.9 percent. Alan Berube and Tracy Kornblatt, The Brookings Institution, *Step in the Right Direction: Recent Declines in Refund Usage Among Low-Income Taxpayers* (Apr. 2005); IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Years 2002, 2003, 2004) and IRS ETA Data: RAL Indicator (Tax Years 2002, 2003, 2004).

4 PowerPoint Presentation to the Senior Leadership Team, Refund Anticipation Loans (RALs), 9 (June 2005); Draft RAL Anticipation Loans (RALs) PowerPoint Presentation, 5 (Oct. 24, 2005).

or RACs, which are described in more detail below, and although the 2005 data was intended to include only RALs, the IRS has acknowledged that the data still includes an unquantifiable number of RACs.[5]

A recent study conducted by the McDonough School of Business at Georgetown University found that over 75 percent of calendar year (CY) 2004 RAL customers were either (1) under the age of 45 and married with children or (2) unmarried (any age) with children. Approximately 74 percent of CY 2004 RAL customers had a lower or moderate household income (under $39,999). Further, the study showed that many RAL customers have limited ability to borrow because their current resources are constrained, and they use the loan proceeds to resolve a specific problem such as bills or unexpected expenses.[6]

RALs are attractive to taxpayers for a variety of reasons, including the following[7]:

- **Quick Turnaround Time.** One main reason taxpayers enter into RALs is the quick turnaround time associated with these products. Taxpayers can receive the loan proceeds as soon as an hour after transmission.[8] Taxpayers value this feature of RALs if they have a real or perceived immediate financial need.
- **The Unbanked.** Taxpayers may be unable to receive their tax refunds via direct deposit because they do not have bank accounts. To the "unbanked," a RAL may seem like the only way to receive a quick tax refund.
- **Payment of Preparation and Filing Fees.** Taxpayers who are unable to pay tax preparation fees may also choose a RAL product, because the loan proceeds are first applied to the tax preparation fees.[9]

Costs

RAL fees combined with return preparation and electronic filing fees significantly reduce a taxpayer's refund.[10] For example, at H&R Block's corporate owned offices, the

[5] ETA Response to TAS Information Request (Aug. 25, 2005).

[6] Gregory Elliehausen, Senior Research Scholar, Credit Research Center, McDonough School of Business, Georgetown University, *Consumer Use of Tax Refund Anticipation Loans*, Monograph No. 37, 40-50, 59-66 (Apr. 2005) (This study, which analyzed the findings of a national telephone omnibus survey, was supported, in part, by a grant from Jackson Hewitt Tax Services).

[7] *Id.* at 1.

[8] H&R Block, Inc., 10-K (Apr. 30, 2003).

[9] Tax Related Financial Products Can be Costly: Field Hearing Before the U.S. Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, 109th Cong. (Apr. 15, 2005) (Statement of Robert A. Weinberger, H&R Block).

[10] RALs are similar to payday loans, which are short-term cash loans based on personal checks held for future deposit or electronic access to the borrower's bank account. Borrowers write a personal check for the amount borrowed plus the finance charge and receive cash. Lenders hold the personal checks until the next payday when payment is due. Borrowers can redeem the check for cash, allow the check to be deposited, or pay the finance charge to roll the loan over for another pay period. Payday loans range from $100 to $500 and have average terms of about 14 days. *See Loan Sharks in the Water: Payday Lending,* at http://www.nypirg.org/consumer/payday/default.html) (last viewed on Oct.13, 2005). Typical annual percentage rates (APR) for payday loans range from 391 percent to 443 percent. Keith Ernst, John Farris, Uriah King, *Quantifying the Economic Cost of Predatory Payday Lending,* The Center for Responsible Lending 3 (Dec. 2003).

bank's loan fee on a $3,000 loan amounts to $99.95 with a 114 percent annual percentage rate (APR), in addition to the tax preparation, filing and loan processing fees.[11]

Existing Alternatives

Taxpayers who are due a refund have the following alternatives to RAL products.

Filing Without Purchasing a Product. The taxpayer may choose to file the return without purchasing a product to expedite the refund. Each of the following options has a different turnaround time, but these periods will likely decrease as the IRS further implements the Customer Account Data Engine (CADE), which has the potential to deliver refunds more rapidly: [12]

- *E-File/Direct Deposit.* The quickest method of receiving a refund is to electronically file the return and direct the IRS to deposit the refund into the taxpayer's bank account. This option allows the taxpayer to receive the refund in as little as 10 days.
- *E-File / Paper Check.* If the taxpayer e-files and directs the IRS to send a paper check, the refund will be issued within three weeks after the acknowledgement date.
- *Paper Filing / Direct Deposit.* If the taxpayer files by paper and chooses to receive the refund by direct deposit, the taxpayer will receive the funds within approximately five weeks from the date the IRS receives the return.
- *Paper Filing / Paper Check.* The slowest way to obtain a refund is to file a return by paper and choose to receive a paper check in the mail. Here, the taxpayer will receive the funds within six weeks of the date the IRS receives the return.

Refund Anticipation Checks (RACs). A RAC is a non-loan alternative to RALs. With a RAC, the bank sets up a temporary account to receive the refund. Once the refund is deposited into this account, the bank deducts return preparation, filing, and bank processing fees before disbursing the remainder of the funds to the taxpayer. RAC bank processing fees average approximately $28. While the RAC carries little or no risk for the bank, the tax return preparer is at risk because the preparation and filing fees will not be paid if the refund is not received. Preparers compensate for this risk in their pricing structure. Unbanked taxpayers may incur additional fees to cash their checks.[13]

Debit Cards. Preparers are beginning to offer prepaid debit cards as another option for unbanked taxpayers. Debit cards allow the taxpayer to receive the refund in approximately one to two weeks, which is no different than the e-file/direct deposit option described above. These cards usually have an initial sign-up fee of approximately $25 as

[11] Tax Related Financial Products Can Be Costly: Field Hearing Before the U.S. Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, 109th Cong., (Statement of Robert A. Weinberger, H&R Block). (Apr. 15, 2005).

[12] IRS Pub. 17, *Your Federal Income Tax* 11 (2004); IRS, *Topic 152-Refunds-How Long They Should Take,* at http://www.irs.gov/taxtopics/tc152.html; IRS, *IRS e-file and Direct Deposit Continue to Outpace Last Year's Results,* at http://www.irs.gov/newsroom/article/0,,id=136599,00.html.

[13] RAL Industry Briefing to the National Taxpayer Advocate (Oct. 27, 2004).

well as additional transaction fees. Opponents of this method have raised concerns that such cards do little to encourage saving.[14]

IRS Drives the Demand

The IRS must take responsibility for driving taxpayers to purchase RALs. The IRS influences the demand for bank products by: (1) failing to deliver refunds in the quickest manner possible and (2) failing to provide RAL and RAC alternatives for the "unbanked."

Delays in Refund Delivery

Currently, if a taxpayer does not purchase a bank product, the quickest way to receive a tax refund is to file electronically and request a direct deposit into a bank account. As discussed above, the refund turnaround time for this method is as few as 10 days.[15] In fact, with the implementation of the Customer Account Data Engine (CADE), the IRS can turn around a refund within two to three days, but pursuant to its Revenue Protection Strategy (RPS), the IRS first runs the refunds through Criminal Investigation screens and the Dependent Database, increasing the turnaround time to five days.[16] For taxpayers who purchase bank products due to the speed of the refund turnaround time, shortening the time to three days might make a world of difference, especially if the taxpayers are sufficiently informed about their options and the cost of alternatives. Given that the RPS delays the delivery of refunds, competing tax administration concerns contribute to the demand for RALs. It is incumbent on the IRS, then, to review the timeframes for RPS screening and shorten them as much as possible.

Offering Alternatives for the Unbanked

The IRS also drives "unbanked" taxpayers to bank products by not offering these taxpayers a method of receiving refunds that does not involve a bank account. Further, given the high demand for RAL products by Earned Income Tax Credit (EITC) recipients,[17] the IRS and the Department of Treasury need to develop alternative means of refund

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[14] Caroline E. Mayer, *Preparers Moving to Tax-Refund Debit Cards*, Washington Post, F01 (Apr. 10, 2005).

[15] IRS Pub. 17, *Your Federal Income Tax* 11 (2004).

[16] Draft RAL Anticipation Loans (RALs) PowerPoint Presentation, 5 (Oct. 24, 2005).

[17] Over 61 percent of RALs processed in 2005 included EITC funds. In tax year 2002, approximately 57 percent of RAL customers were EITC recipients. IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Years 2002, 2003, 2004); IRS ETA Data: RAL Indicator (Tax Years 2002, 2003, 2004); Alan Berube and Tracy Kornblatt, The Brookings Institution, *Step in the Right Direction: Recent Declines in Refund Usage Among Low-Income Taxpayers* (Apr. 2005). Further, in a recent Brookings Institution study focusing on Cleveland taxpayers for Tax Year 2002, 47 percent of EITC claimants purchased RALs and ten percent of taxpayers without EITC purchased RALs. Alan Berube, *Connecting Cleveland's Low Income Workers to Tax Credits*, Presented at the Levin College Forum, available at http://www.brookings.edu/metro/speeches/20050113_connectingcleveland.htm, 17 (Jan.13, 2005). Proponents of RALs state that the data provided by IRS actually combines RALs and Refund Anticipation Checks (RACs) and that at least one-half of the number of RAL customers in the IRS data actually received RACs. RAL Industry Briefing to the National Taxpayer Advocate (Oct. 27, 2004). However, the IRS has no way to verify these claims that are based on data collected by the RAL/RAC industry.

delivery to ensure that taxpayers do not unnecessarily spend EITC benefits on high fees. Two methods worthy of serious consideration are Electronic Benefit Transfer (EBT) and Electronic Transfer Accounts (ETA):

Electronic Benefits Transfer (EBT): As the name implies, Electronic Benefits Transfer (EBT) is the electronic transfer of public entitlement payments, such as welfare or food stamps. This delivery system is replacing paper food stamps in all 50 states, the District of Columbia, and three territories (Puerto Rico, the U.S. Virgin Islands, and Guam).[18] Individuals who receive food stamps access those benefits at Point of Sale (POS) terminals at retailers. EBT has also been expanded to other assistance programs involving cash benefits, such as Temporary Assistance to Needy Families (TANF), and Women, Infants and Children (WIC). EBT systems typically involve issuing a benefit card, resembling a debit card or stored-value card, which the recipient can use together with a personal identification number (PIN) to access benefits through an electronic network, such as ATMs.[19]

An EBT system could deliver EITC benefits and keep the associated fees low, as is the case with other programs using this method of delivery.[20] Further, the IRS could deliver the non-EITC portion of refunds through a similar stored-value card format.

The private sector also uses stored value cards to serve the unbanked. For example, an increasing number of employers have replaced paper paychecks with electronic payroll cards, a mechanism by which an employee's pay is loaded on a stored-value card. A Celent Communications study estimates that 10 percent of unbanked households were

18 USDA, FNS, *The Food Stamp Program State by State EBT Map*, at: http://www.fns.usda.gov/fsp/ebt/ebt_map.htm (Jul. 2004).

19 Food stamps are only available to purchase food at POS terminals while recipients can access cash benefits at ATMs. Michael A. Stegman, et. al., *The State of Electronic Benefit Transfer (EBT)*, Center for Community Capitalism: Chapel Hill, NC, December 2003, 5-7; Federal Reserve Bank of Chicago, Consumer Information: *Electronic Money*, available at http://www.chicagofed.org/consumer_information/electronic_money.cfm. See *Stored Value Cards: An Alternative for the Unbanked?*, available at http://www.ny.frb.org/regional/stored_value_cards.html.

20 For example, the U. S. Department of Agriculture regulates the EBT of food stamps by preventing state agencies from charging food stamp retailers any fees associated with the EBT of food stamps. Food Stamp Act, §7(h)(2), 7 U.S.C. § 2016(h)(2). Currently, USDA regulations prohibit merchants from charging fees and surcharges on purchases made with electronic food stamps. However, these regulations do not apply to non-food stamp benefits like TANF. Excluding New Mexico, all states that deliver cash benefits (like TANF) allow EBT vendors to restrict the number of allowable free cash transactions. Many states offer four free ATM transactions per month to a recipient. After that, the EBT vendor is allowed to charge fees. In most states the vendor fee is $ 0.85 or $ 1.00. In many states, recipients can get cash back from their (non-food stamp) benefits at a POS machine at a grocery store; again, many states offer a number of free transactions and then charge for transactions above that number. Michael A. Stegman, et. al., *The State of Electronic Benefit Transfer (EBT)*, Center for Community Capitalism: Chapel Hill, NC, 19 (December 2003), Joulia Dib, et. al, *Electronic Benefit Transfer (EBT) Programs: Best Practices to Serve Recipients*, Consumers Union, August 2000, 27-28.; *See Electronic Benefit Transfer (EBT) Programs in the States*, at http://www.consumer-action.org/english/canews/1998_July_EBT-eft/index.php#topic_06 (last viewed on Oct. 17, 2005). As a direct Federal payment to the taxpayers, the U.S. government could set terms for EBT vendor transactions by contract with the vendors (*e.g.*, the services provided for free or for additional charges).

using payroll cards in 2002, with the number expected to rise to 30 percent in 2005.[21]

Payroll cards benefit both employers and employees. For employers, payroll cards facilitate payments to employees who do not make use of direct deposit, including the unbanked, and reduce the cost of replacing lost or stolen paychecks. Employees benefit by not having to pay check-cashing fees. They may also be able to manage their cash flow better by not having to cash out their entire paychecks at once.[22] However, some consumer advocates say the cards simply transfer costs from employer to employee. While the first withdrawal of each pay period is typically free, cardholders do incur fees for any number of transactions, such as opening or maintaining an account, ATM withdrawals, balance inquiries, purchase transactions and increasing the card balance. Nonetheless, the accumulation of fees on payroll cards is still significantly lower than check cashing fees, and individuals can learn how to avoid certain fees through outreach and education.[23]

Expand electronic transfer accounts (ETA) eligibility to include EITC benefits. Electronic Transfer Accounts (ETA) are low-cost bank or credit union accounts set up to receive benefits. Participating federally insured financial institutions make ETAs available to individuals who receive federal benefits, wages, salaries, or retirement payments. The account allows recipients to receive federal payments (except tax refunds) electronically in accordance with the Electronic Funds Transfer (EFT) provision of the Debt Collection Improvement Act of 1996 (DCIA).[24] Linking EITC and other tax refunds to low-cost bank accounts may (1) facilitate account ownership among the unbanked, (2) integrate these taxpayers into the financial mainstream, (3) encourage saving, and (4) promote asset purchase.[25]

Free File

The IRS currently allows members of the Free File Alliance to market RALs and other products through the Free File electronic filing program. The agreement reached between the Free File Alliance and the IRS on October 25, 2005 allows alliance

21 Ellen Seidman, Jennifer Tescher, *From Unbanked to Homeowner: Improving the Supply of Financial Services for Low-Income, Low-Asset Customers*, Presented at "Building Assets, Building Credit: A Symposium on Improving Financial Services in Low-Income Communities," organized by the Joint Center on Housing Studies at Harvard University, 16 (Nov. 18, 2003).

22 Federal Reserve Board, *U.S. Consumers and Electronic Banking, 1995-2003* at http://www.federalreserve.gov/pubs/bulletin/2004/winter04_ca.pdf 5 (Jan. 1, 2004).

23 Barbara Kiviat, *Bye Bye Paycheck*, Time, at http://www.time.com/time/insidebiz/printout/0,8816,493290,00.html (Oct. 6, 2003); OCC, *Payroll Cards: An Innovative Product for Reaching the Unbanked and Underbanked*, at http://www.occ.treas.gov/cdd/payrollcards.pdf 11 (Jun. 2005). Moreover, with respect to tax refunds, the Federal government can establish the fee schedule as part of the agreement with EBT vendors.

24 Debt Collection Improvement Act of 1996 (DCIA), Pub L. No. 104-34, § 31001, 110 Stat. 1321-358. *See Electronic Transfer Accounts: Common Questions*, available at http://fms.treas.gov/eta/questions.html.

25 Sondra G. Beverly, et al., *Linking Tax Refunds and Low-Cost Bank Accounts: Findings from the Extra Credit Savings Program,* 31 (Sept. 2001) (Describing the results from the Shore Bank Study).

participants to market RALs with the following additional requirements:[26]

- Free return preparation and filing cannot be contingent on purchasing a RAL;
- RAL offers must contain "clear language" disclosing terms to taxpayers; and
- Pursuant to a new "consent measure," vendors must obtain the consent of the customer before offering a RAL.

No matter how many disclaimers the IRS posts on the Free File website, taxpayers could easily get the impression that the tax software, as well as any products cross-marketed through the software, has received the "IRS stamp of approval."[27]

Debt Indicator Program

The IRS plays a significant role in making RAL products less risky for banks and loan retailers by offering the Debt Indicator (DI) program. With the taxpayer's consent, DI signals to participating authorized IRS e-file providers whether taxpayers' refunds will be reduced by outstanding tax liabilities or other debts. For example, the IRS could schedule such offsets for previously assessed liabilities, or by the federal government's Financial Management Service (FMS) for child support or federal debts such as student loans.[28] Participating providers use the program to evaluate the eligibility of taxpayers applying for RALs. The taxpayer must sign a consent form for the Debt Indicator program to disclose information to the provider.[29]

The IRS facilitates RAL transactions when it discloses Debt Indicator information to RAL providers to determine a customer's eligibility for a RAL. Given the high cost of RALs and the below-discussed high sanction rate of EROs, the IRS needs to assess whether the perceived benefits of the program outweigh the risk of the inevitable and reasonable perception that the agency implicitly endorses RAL transactions.[30] The

[26] Allen Kenney, *IRS, Industry Reach Agreement on Free File,* Tax Analysts Tax Notes Today, 2005 TNT 206-2 (Oct. 26, 2005).

[27] *Free Electronic Filing and National Taxpayer Advocate Annual Report:* Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 108th Cong. 29 (2003). Rep. Pomeroy stated, "I am interested in when the Commissioner said there is no express or implicit endorsement of products, the fact that there is a public-private partnership and you can access these vendors through the IRS Web site leaves me a little concerned that there may be an implicit statement by the IRS that these are appropriate products, and yet there does not seem to be an active review of whether the products are indeed appropriate. So, maybe we can install that going forward."

[28] IRC § 6402(d). Notice 99-58, 1999-2 C.B. 693, 1999-51 I.R.B. 693 (Dec. 20, 1999); IRS Communications and Liaison, Operations Flash, *Direct Deposit Indicator, 2000-6* (Dec. 10. 1999).

[29] The IRS requires tax preparers who receive the Debt Indicator to have return preparation software that includes a mandatory consent to disclose the debt indicator. IRS Publication 3614, Application for Memorandum of Agreement – Debt Indicator; Notice 99-58, 1999-2 C.B. 693, 1999-51 I.R.B. 693 (Dec. 20, 1999). However, it is unclear whether preparers adequately explain the arrangement and whether taxpayers feel compelled to consent in order to get their money quickly.

[30] The IRS believes the program (1) significantly increases electronic filing, (2) increases service to taxpayers, (3) decreases RAL fees, and (4) assists RAL lenders in identifying fraudulent returns. Amy Hamilton, *Taxwriters Zeroing in on Rapid Refund Loans,* Tax Analysts Tax Notes Today, 2001 TNT 67-3 (Apr. 5, 2001); Notice 99-58, 1999-2 C.B. 693, 1999-51 I.R.B. 693 (Dec. 20, 1999).

National Taxpayer Advocate is aware that the Debt Indicator Program may keep RAL bank fees lower by reducing the associated risk to the banks.[31] Further, the program benefits all taxpayers who e-file by informing them of outstanding federal and certain other debts.[32] Thus, before deciding to continue or terminate the program, the IRS should evaluate the potential impact of termination on taxpayers as well as on refund fraud, RAL fees, and e-file rates.

Inadequate Oversight by the IRS

The IRS denies any responsibility for the oversight of the RAL industry.[33] Despite this claim, Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*, lists several requirements to which authorized IRS e-file providers must adhere to avoid sanctions, including (1) certain communications to taxpayers to ensure that they are well informed about the terms and fees of the RAL, (2) fee restrictions, and (3) advertising standards, as well as a number of administrative rules not directly pertaining to RALs.[34]

The IRS has the authority to either issue a warning or sanction a violation of Publication 1345, the latter of which could entail a written reprimand or the suspension or expulsion of the ERO from the e-file program.[35] The Small Business / Self-Employed Operating Division (SB/SE) conducts e-file monitoring visits at ERO establishments to

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31 When the IRS eliminated the program in 1995, RAL fees increased and e-filing decreased by approximately 16 percent. PowerPoint Presentation to the Senior Leadership Team, *Refund Anticipation Loans (RALs)* 7 (Jun. 2005).

32 In fact, 84 percent of e-filers did not request a RAL in 2005. Draft RAL Anticipation Loans (RALs) PowerPoint Presentation, 15 (Oct. 24, 2005); Information Provided to TAS and Taxpayer Advocacy Panel (Sept. 23, 2005).

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33 Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*, states:

> The IRS is in no way involved in or responsible for RALs. All parties to RAL agreements, including electronic return originators (EROs), must ensure that taxpayers understand that RALs are interest bearing loans and not substitutes for a faster way of receiving a refund. The ERO should advise the taxpayer that if a Direct Deposit is not received within the expected time frame for whatever reason, the taxpayer may be liable to the lender for additional interest on the RAL. The Service has no responsibility for the payment of any fees associated with the preparation of a return, the transmission of the electronic portion of a return, or a RAL.

IRS Pub.1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns* 50-52 (Rev. 01-2001). In a response to a Taxpayer Advocacy Panel Elevated Recommendation, the IRS noted that three locations within the Free File website inform taxpayers that they are under no obligation to purchase or use products and or services made available by Alliance members. Taxpayer Advocacy Panel Annual Report 19 (Dec. 31, 2004).

34 IRS Pub. 1345, 44-45. *See also* Pub. 1345A, *Filing Season Supplement for Authorized IRS e-file Providers: Tax Year 2004*, 15.

35 Rev. Proc. 2000-31, 2000-31 I.R.B. 146, § 7. To become an ERO, an applicant must submit to a suitability check that covers all principals of his or her firm and all responsible officials listed on Form 8633, *Application to Participate in the IRS e-file Program*. A suitability check may entail an FBI criminal background check, a credit history review, an IRS records search to ensure a history of tax compliance, and/or a history check for prior non-compliance in IRS electronic filing programs. *See* Internal Revenue Service, Publication 3112, *The IRS e-file Application Package* (Rev. 08- 2003); Internal Revenue Service, Publication 1345, *Handbook for Authorized IRS E-File Providers of Individual Income Tax Returns*, 77-78 (Rev. 2001).

verify compliance with Publication 1345 as well as Revenue Procedure 2000-31.[36] The ERO Visitation Checksheet, which SB/SE employees use during visits, asks a series of questions including two significant RAL-related ones: (1) "How do you inform the client that the bank product is a loan?" and (2) "Do you assist your clients in the negotiation/cashing of their refund check or RAL?" There is no indication on the checksheet that the visitation confirms the actual procedures followed with respect to the communication of RAL terms, fees, or alternatives.[37] Further, once an ERO is found to be noncompliant, the sanctions imposed are nonmonetary and in many cases allow the ERO to continue preparing returns and marketing RALs.[38]

During the 2004 calendar year, more than 197,000 EROs were registered with the IRS and approximately 142,000 of them filed at least one Form 1040, *Individual Income Tax Return*. During the same period, SB/SE conducted 1,294 visits, which resulted in the following warnings and sanctions:[39]

TABLE 1.8.1, ERO SANCTIONS AND WARNINGS FOR 2004

Sanctions	Quantity	Warnings	Quantity
Written Reprimands	154		
Recommended Suspensions	244	Warnings	224
Immediate Suspensions	31		
Total Sanctions	**429**	**Total Warnings**	**224**

This data indicates that approximately 33 percent of the EROs visited (429 sanctions / 1294 visits) received a formal sanction. An additional 17 percent of the sites visited (224 warnings / 1294 visits) received a warning for not adhering to some part of the required actions for ERO participants.[40] Although the noncompliance rate is an estimate, the data indicates that the IRS faces a formidable challenge in overseeing EROs and enforcing the requirements of Publication 1345 in a meaningful manner. At the very least, this data supports the need to conduct more random visits to determine

36 IRM § 4.21.1 (Jan. 2003).

37 IRM Exhibit 4.21.1-6, ERO Visitation Checksheet (Jan. 2003). The completed checksheet compiles over 50 different information items.

38 For a detailed discussion of IRS due diligence of EROs as well as the National Taxpayer Advocate's legislative proposal to increase monetary penalties imposed on EROs, *see* National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

39 SB/SE exceeded its goal to visit 1,181 EROs. SB/SE, Examination General Processes, Response to Information Request (Apr. 14, 2005).

40 These figures cannot be generalized to the total population because the sites selected for visitation were not all selected on a random basis. A portion of the sites were selected randomly, but the dataset used to calculate these figures do not have sufficient detail to conduct the analyses for solely the randomly selected site visits. Additionally, after providing a copy of the document to operations for review and comment, a different dataset was provided that included counts somewhat different from the original data. Due to time constraints, it was not possible to identify which dataset was most accurate, so the figures reported here are based on the originally supplied data.

whether this high rate of noncompliance is present in the general ERO population.[41]

Perhaps more troubling is the fact that IRS currently allows EROs to purchase up to a 49 percent ownership interest in each RAL sold.[42] When EROs can own the RALs they sell, they have a financial incentive to market these products, which may compromise their ability to look to the best interests of the taxpayers.

The National Taxpayer Advocate continues to support her previously stated proposal to regulate return preparers, which would include EROs. To date, however, the IRS has devoted few resources to researching the need for or the feasibility of this regulatory program.[43]

Cross-Collection

Standard RAL contracts typically include cross-collection provisions, to which the taxpayer must consent to receive RAL proceeds.[44] The provisions grant the contracting bank the authority to share information with third party banks that have entered into a cooperative agreement for cross-collection purposes, specifically sharing information about delinquencies owed to other banks by RAL applicants. Under this cross-collection arrangement, a taxpayer who signs a RAL contract consents to allow the contracting bank to share information with participating banks, deduct from the loan proceeds any outstanding amounts owed on a RAL issued to the taxpayer by a third party bank, and

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[41] The preliminary data for a partial calendar year 2005 shows improvement in the compliance rate. Of the 1,104 visits conducted, 143 warnings (13 percent) and 179 sanctions (16 percent) were imposed, which totals an approximate 29 percent rate of noncompliance for the partial year. It is our understanding that SB/SE only imposes one of the listed warnings or sanctions per year. Therefore, EROs will not receive multiple warnings and sanctions within a single year. However, the estimated noncompliance rate may be an inflated figure due to the fact that visits were not conducted in an entirely random manner. There are four types of e-file monitoring visits: (1) random visits based on a non-discriminatory sample, (2) targeted visits based on selection criteria, (3) mandatory referral visits, and mandatory follow-up visits. SB/SE Responses to TAS Information Request (Apr. 14, 2005 and Sept. 24, 2005). Unlike with the Taxpayer Assistance Centers (TACs) and the Volunteer Income Tax Assistance program, the IRS does not conduct "shopping visits" or "undercover" testing of EROs to verify that procedures are actually followed. Volunteer Return Preparation Program Quality Improvement Process (VRPP QIP) TAS Briefing, PowerPoint screens 5 – 11 (Oct. 18, 2005) (The IRS conducts shopping visits of the TACs. Further, although the IRS does not conduct shopping visits on VITA sites, it has partnered with the AICPA to conduct such visits. It has also invited TIGTA to return to conduct future undercover visits of the sites). For more information, *see* National Taxpayer Advocate 2004 Annual Report to Congress 119 -120.

[42] IRS Pub. 1345, *Handbook for Authorized IRS E-File Providers of Individual Income Tax Returns* 44 (Rev. 2001); IRC § 267(b)(2).

[43] For more a more detailed discussion of this proposal and the IRS's response, *see* National Taxpayer Advocate 2002 Annual Report to Congress 216-230; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2004 Annual Report to Congress 67-88.

[44] For example, the Santa Barbara Bank & Trust Refund Processing and Refund Anticipation (RAL) Application and Agreement (Rev. 10/25/04) contains a provision on the first page informing the customer that the bank may deduct the amount of delinquencies on third party RALs. However, the agreement does not mention that the bank will share private tax return information with other banks until provision 6.a, on page 3 of the 5-page document.

transmit the funds to the third party bank.[45] It is unclear if RAL customers fully understand the ramifications of these cross-collection provisions or if they would purchase the products if they knew these agreements exist.

It is questionable whether cross-collection terms included in RAL contracts are enforceable under the modern case law approach to contracts of adhesion or standard form contracts. In general, each party to a contract has the duty to read its terms. However, modern contract law has not strictly applied the "duty to read" principle in standard form contracts where there is no true assent to a particular term, the term contravenes public policy, or the term is unconscionable. These three rationales are often treated as interchangeable, but the modern approach generally evaluates whether a disparity of bargaining power renders one party at the mercy of another with no ability to negotiate the particular provision in question. In addition, the courts consider whether the term in question is used to the stronger party's advantage and is unknown to the weaker party. In such cases, the courts generally impose on the stronger party the burden to prove that the terms were explained to the weaker party and that both parties reached a voluntary meeting of the minds.[46] In addition, the Restatement (Second) of Contracts goes one step further and holds a provision of a standardized agreement unenforceable if a reasonable person would not have expected to find such a clause in the contract.[47]

Thus, based on contract law principles, we believe a cross-collection provision in a standardized RAL agreement may be unenforceable. The banks have a grossly disproportionate bargaining power in relation to the taxpayer and the provision unilaterally benefits the bank. Moreover, a reasonable person may not expect a RAL agreement to provide that the contracting bank may act as the debt collector for a third party bank.

It is interesting to note that federal law prohibits banks from exercising their right to offset Social Security benefits.[48] Although no current statutory provision prohibits banks from offsetting federal tax refunds, it would make sense to protect EITC benefits in the same manner as Social Security. At the very least, the National Taxpayer Advocate believes that banks should be barred from transferring EITC under a cross-collection arrangement to satisfy a debt to a third party bank.[49]

Legislative Action

Members of the U. S. Senate have identified refund anticipation loans as a problem. The high cost of RALs was the subject of a hearing held in St. Paul, Minnesota on

45 Alan Berube, Anne Kim, Benjamin Forman, and Megan Burns, *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC*, The Brookings Institution and The Progressive Policy Institute 5 (May 2002).

46 7 Joseph M. Perillo, Corbin on Contracts §§ 29.8 - .10.

47 Restatement (Second) of Contracts § 211.

48 42 U.S.C. § 407(a).

49 *See* Additional Legislative Recommendation: *Debt Collection Techniques on EITC Benefits by Refund Anticipation Loan Industry, infra.*

April 15, 2005 by the Permanent Subcommittee on Investigations.[50] Further, RAL practices are addressed in S. 324, the Taxpayer Abuse Prevention Act, introduced on February 9, 2005 by Senators Akaka, Bingaman, Dayton, and Durbin. The bill (1) prohibits the debt collection techniques in which RAL providers engage (cross-collection),[51] (2) prohibits RALs that utilize EITC benefits, (3) terminates the Debt Indicator program, (4) prohibits mandatory arbitration clauses for RALs, (5) requires Treasury to provide the opportunity for lower and moderate income taxpayers to open low-cost deposit accounts at FDIC insured banks through the use of appropriate tax forms, and (6) excludes any electronically filed returns that resulted in refunds distributed by RALs from counting toward the electronic filing goal of 80 percent.[52]

Several states and localities have passed laws requiring disclosures to RAL customers regarding the products' associated fees, terms, and alternatives.[53] While these laws protect RAL customers, the lack of uniformity among the requirements actually creates an administrative burden on the banks. Several financial institutions have indicated to the National Taxpayer Advocate that they favor a comprehensive federal law that would supersede the individual state requirements.[54]

CONCLUSION

Despite its claim to the contrary, the IRS plays a significant role in the RAL industry. The IRS drives demand by delaying refund turnaround time under its Revenue Protection Strategy. Further, although its full impact is currently unknown, the availability of the Debt Indicator aids RAL providers. Given that a significant percentage of RAL customers are EITC recipients, the IRS has a compelling reason to consider improved oversight of the industry as well as seriously consider alternative refund delivery methods. Finally, cross-collection provisions in RAL contracts reduce risks for RAL providers but raise serious legal questions.

50 *Tax Related Financial Products Can Be Costly*: Field Hearing Before the Permanent Subcomm. on Investigations, Senate Comm. on Homeland Security and Governmental Affairs, 109th Cong. (2005) (Statement of Sen. Norm Coleman).

51 Sec. 3(a) of S. 324, "Prohibition on Debt Collection Offset" provides "No person shall, directly or indirectly, individually or in conjunction or in cooperation with another person, engage in the collection of an outstanding or delinquent debt for any creditor or assignee by means of soliciting the execution of, processing, receiving, or accepting an application or agreement for a refund anticipation loan or refund anticipation check that contains a provision permitting the creditor to repay, by offset or other means, an outstanding or delinquent debt for that creditor from the proceeds of the debtor's Federal tax refund." S. 324(3)(a) 109th Cong. (2005).

52 S. 324, 109th Cong. (Feb. 9, 2005). *See also* H.R. 969, 109th Cong. (Feb. 17, 2005). The Low Income Taxpayer Protection Act, S. 832, 109th Cong. (Apr. 18, 2005) and H.R. 894, 109th Cong. (Feb. 17, 2005) required the registration of income tax preparers and RAL providers and curbs demand for RALs by speeding up the e-file process.

53 *See, e.g.,* Conn. Gen. Stat. § 42-480; Minn. Stat. § 270.30; N.C. Gen. Stat. §§ 53-245 to -254; Wis. Stat. §§ 421.301 and 422.310; N.Y.C. Admin. Code § 20-739.

54 Industry Briefing to the Taxpayer Advocate Service (Oct. 27, 2004).

IRS COMMENTS

Although most taxpayers in fact do not get RALs (in 2005, only 16 percent of all e-filers requested RALs, and RAL usage by EITC taxpayers appears to be dropping), the IRS is committed to helping ensure that taxpayers, and in particular, low income taxpayers, have adequate information to make informed financial decisions with regard to their tax refunds. Indeed, we recognize that low income taxpayers may be particularly attracted to RALs because the loans appear to deliver refunds almost immediately and the cost of the tax preparation is rolled into the transaction. That is why we prescribe specific disclosure requirements, fee restrictions, and advertising standards on return preparers who file electronically, and impose penalties on tax return preparers who make unauthorized disclosures or uses of information furnished to them in connection with the preparation of income tax returns.

We do not agree, however, that the IRS drives the demand for RALs. In fact, the IRS' ability to affect taxpayer behavior with regard to RALs is relatively limited. Availability of RALs and the related demand for them is due to a number of factors. First, legislation increasing the size of refunds for low income working taxpayers provided a large financial asset with which taxpayers could seek credit. Second, the National Bank Act (12 U.S.C. §§ 85-86) enables lenders to operate nationally without being subject to state or local regulation. Finally, many RAL users do not have bank accounts. Thus, they are drawn to alternatives like RALs, which do no require them to be "banked." Taken together, these factors explain much of the reason why consumers continue to purchase RALs.

While we continue to work to reduce the time it takes to deliver refunds, it is unclear whether, in the near term, the IRS will be able to approach or match the near "instantaneous" availability of RALs – nor is it clear, given fraud and accuracy concerns, whether such a process is advisable. Moreover, much of the regulatory oversight of RALs is in banking law and therefore not administered by the IRS. Thus, the IRS has little say over interest rates or other banking-related fees associated with RALs, as well as cross-collection issues.

Despite these limitations, the IRS continues to explore ways to help taxpayers make informed choices and to ensure they understand the implications of the decisions they make. Recently, the IRS issued proposed guidance updating the rules under IRC § 7216 on unauthorized disclosure and use of tax return information by tax return preparers to take into account the commonplace practice of electronic return preparation and filing. These new rules were proposed, in part, because existing regulations are silent on taxpayers' consent to the disclosure and use of tax return information in an electronic environment. Additionally, over the next several months, the IRS will conduct a thorough evaluation of RALs as part of our response to a recent legislative mandate. In doing so, we will work with the National Taxpayer Advocate to develop objective data that can be used to help guide IRS policy with regard to RALs. We also recognize that the relationship between the tax preparer and the RAL provider deserves special scrutiny and will consider this issue as part of our report.

Before that analysis for the report is conducted, however, we believe that several of the points identified by the National Taxpayer Advocate are not necessarily supported by existing evidence. Here are responses to the points raised in the National Taxpayer Advocate's discussion of RALs.

The IRS is continually working to deliver taxpayer refunds in as short as time as possible – an approach which we believe will lessen, but not eliminate, demand for RALs. Despite decreasing waits for refunds, large numbers of taxpayers continue to use RALs. There are a number of theories to explain this behavior, but the evidence is only anecdotal. Perhaps the strongest explanation is that RAL consumers have a very short time value of money – that is, they are willing to pay what constitutes an extraordinarily high price to gain near immediate access to their refunds (or a loan equivalent to most of their refunds), rather than wait just a few days and not pay a fee. Even more telling is the high degree of satisfaction RAL users appear to experience – at least according to the Georgetown University monograph the National Taxpayer Advocate cites. In that paper, Dr. Elliehausen makes a strong case that people who use RALs are happy with the product and at least somewhat aware of the financial transaction in which they have engaged.

It is unlikely that the IRS will ever be able, or necessarily want, to deliver refunds in the near "instantaneous" fashion that taxpayers can obtain RALs. While we will continue to work to shorten the wait time, fraud and error correction screens may add days to the process – days some taxpayers are unwilling to wait if a RAL is available.

The IRS assists ALL taxpayers by offering the Debt Indicator (DI). Removing the DI could actually hurt low income taxpayers. Critics of RALs often focus on the IRS' provision of the DI as a way of facilitating RALs. While the DI does serve as a way to reduce risk for lenders, it also reduces risk to borrowers. In fact, as acknowledged by the National Taxpayer Advocate in her report, discontinuing the DI could have a significant detrimental impact on the very low-income taxpayers about whom the National Taxpayer Advocate and the IRS are concerned.

Many RAL consumers have shown little responsiveness to the prices they must pay to obtain the loans. Thus, while lenders may raise RAL fees to compensate for the increased risk posed by the loss of the DI, borrowers are still likely to be willing to pay these higher rates for the same product or simply opt for another financial product with lower, but still high fees. Without the DI, however, those taxpayers who do have their refunds offset will find out only *after* they receive their RALs – and then find themselves with a new, high-interest loan without funds to repay it. In 2004 alone, 1.1 million taxpayers were spared delinquencies or defaults because of the DI.

In short, the IRS believes that eliminating the DI could leave many low-income taxpayers with more debt and fewer resources to repay that debt than they would have had the IRS provided an indicator. It is also important to note that the DI goes to *all* taxpayers who file electronically and claim a refund, not just to those who want to purchase a RAL. Thus, eliminating the DI would reduce service to taxpayers generally – not only those taxpayers who want to purchase RALs.

The IRS conducts meaningful reviews of RAL marketing practices during its reviews of Electronic Return Originators (EROs). Far from indicating a problem, the high rate of sanctions of EROs shows that the IRS selection methodology is effective. It is true that in 2004 nearly 50 percent of EROs who underwent a compliance visit received either a warning (30 percent) or a sanction (20 percent). However, instead of indicating massive problems as the National Taxpayer Advocate contends, this high rate suggests we have an effective selection methodology. In other words, the EROs we visited were selected because we believed they had problems – and it turned out that we were right. It is also important to note that RAL marketing practices by EROs are only one component of the compliance visit. Therefore, the sanctions that have been imposed are not necessarily attributable to noncompliant behavior involving RALs.

In general, EROs tend to be highly compliant. When the IRS visited EROs at random, only 7.8 percent were sanctioned. The National Taxpayer Advocate's discussion of this subject draws exactly the wrong conclusion from the data.

TAXPAYER ADVOCATE SERVICE COMMENTS

Congress has mandated that the IRS and the National Taxpayer Advocate work together to draft a report to be submitted by June 20, 2006, addressing many issues discussed in this Most Serious Problem. We look forward to working closely with the IRS on issues related to the Debt Indicator program, cross-collection practices, the use of RALs, and refund delivery alternatives.[55]

IRS Role in Regulating RAL

The IRS states that the regulation of RAL is beyond its purview and cites the National Bank Act as a bar to action on the part of the IRS. The National Taxpayer Advocate finds this demurral to be beside the point. Throughout this report, the IRS describes cross-agency initiatives that is undertaking and even spearheading to address problems it deems to be important.[56] The IRS's failure to actively engage with regulators and other overseers of national banks, such as the Office of Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve, and even the Treasury's Office of Financial Education, to address these problems, indicates a failure of commitment to an issue that harms taxpayers. The IRS should serve as a convener of these oversight agencies and take the lead in addressing this issue comprehensively through a cross-

[55] H.R. Conf. Rep. No. 109-307 (Nov. 18, 2005) provides:

> The conferees direct the IRS, in consultation with the National Taxpayer Advocate, to report by June 30, 2006 on uses of the Debt Indicator Tool–and whether it facilitates the use of refund anticipation loans (RALs)–the debt collection offset practice, the use of RALs, and evaluations of RAL alternatives, and use of debit cards for refunds, including recommendations on how to deliver tax refunds more quickly."

[56] *See, e.g.*, Most Serious Problems: *Identity Theft*, *infra*; and *Cash Economy* and *Social Security Levies*, *supra*.

government approach. Indeed, the IRS is the one agency whose constituents are most harmed by the lack of oversight.

Taxpayer Satisfaction and Financial Literacy

We support the IRS's initiatives to increase financial literacy and improve disclosure requirements. These initiatives will help taxpayers make informed decisions regarding refund delivery methods. We understand that to some extent demand for RALs will always exist because these products satisfy the need of some taxpayers to receive refunds almost instantaneously. We note, however, that it is not surprising that taxpayers who use RALs are highly satisfied with this product. After all, these taxpayers have few financial options and need their refunds quickly. No one would argue that RAL users would be even more satisfied if they could receive their refunds as quickly as RALs, but at less (or no) expense. The IRS can take steps to minimize demand by reducing the refund turnaround time to the extent possible and offering alternative methods of refund delivery. Given the public policy justification for delivering the EITC, the IRS – working with other federal agencies – should develop a method to deliver the EITC quickly and at no cost to taxpayers. The above-referenced report will address this issue.

Debt Indicator

The National Taxpayer Advocate clearly acknowledged in our discussion above that offering the Debt Indicator (DI) program carries both risks and benefits. That is why we recommend that the IRS evaluate the potential impact of RAL termination on all aspects of tax administration. We look forward to exploring this issue further with the IRS pursuant to the above-referenced legislative mandate. The resulting report will address the uses of DI as well as whether the IRS facilitates the use of RALs by offering the program.

IRS Oversight of EROs

In its response, the IRS states that the high rate of ERO noncompliance found during e-file monitoring does not apply to the general ERO population. We acknowledge that the IRS's selection methodology played a contributing role in the high noncompliance rates found during visits and that the noncompliance is an estimate, at best. Moreover, we have noted that the IRS compliance policies limit per-ERO sanctions to only one each year; thus, noncompliance is most likely understated. Although the 7.8 percent rate of noncompliance found during past random visits is encouraging, without more information regarding the selection process, we cannot apply this rate to the general ERO population. As in other areas relating to oversight of preparers that serve the majority of taxpayers, the IRS has not conducted any statistically valid or comprehensive studies of noncompliance among the ERO population. We would certainly be willing to work with the IRS in the future regarding the methodology used to select ERO sites at random.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS take the following actions:

- Pursuant to Congressional mandate, work closely with the National Taxpayer Advocate to fully analyze and report on such issues as the Debt Indicator program, cross-collection practices, the use of RALs and refund delivery alternatives.
- Work with the Department of Treasury, bank regulators, and banking and consumer stakeholders to develop refund delivery alternatives, with a particular focus on EITC benefit delivery alternatives to ensure that taxpayers do not unnecessarily spend EITC benefits on high fees. Two methods worthy of serious consideration are Electronic Benefit Transfer (EBT) and Electronic Transfer Accounts (ETA).
- Review the effect of the Revenue Protection Strategy (RPS) on refund turnaround times. The IRS should review the feasibility of shortening the RPS timeframes as much as possible.
- Review the ERO Visitation Checksheet used by SB/SE employees during e-file monitoring visits to determine whether it adequately addresses the requirements of IRS Publication 1345 related to RALs and RACs.
- Work closely with the Taxpayer Advocate Service to determine the methodology for randomly selecting ERO sites for e-file monitoring visits. By choosing a representative sample, the IRS can determine the rate of noncompliance among the general ERO population. If the rate of noncompliance found during the resulting random visits is high, the IRS needs to review whether the existing warning and sanction structure actually deters noncompliance in a meaningful manner.

PROBLEMS

PROBLEM

TOPIC #9 **MOST SERIOUS PROBLEM: IDENTITY THEFT**

RESPONSIBLE OFFICIAL

Richard J. Morgante, Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

Identity theft is a fast-growing crime that affects millions of taxpayers. The rate of fraudulent tax returns filed by identity thieves doubled from calendar years 2002 to 2003.[1] Victims of identity theft often find themselves faced with serious tax consequences, and possibly must wait years for their tax account problems to be resolved.

The IRS recently established the Identity Theft Program Office. This office must ensure the IRS (1) revises its procedures to provide consistent, timely, and effective relief to victims of identity theft; (2) develops an effective outreach strategy; and (3) works with other agencies on preventive measures.

ANALYSIS OF THE PROBLEM

Background

Identity theft occurs when someone uses another individual's personal information without permission to commit fraud or other crimes. Examples of identity theft include tax fraud, stealing from the victim's financial accounts, making unauthorized purchases with stolen credit cards, and applying for services or benefits in the victim's name.

Several large data brokers, which compile and sell personal information (such as names, addresses, Social Security numbers (SSNs) and credit reports) to government agencies and private companies have recently reported major breaches of sensitive records. In February 2005, ChoicePoint, Inc. notified more than 140,000 consumers in California that unauthorized parties may have accessed their personal data.[2] In April 2005, LexisNexis reported that up to 310,000 people may have had their profiles stolen from a database that contained sensitive information.[3]

The Federal Trade Commission (FTC) is the lead government agency assigned to monitor identity theft. The FTC's 2004 annual report on fraud listed identity theft as the top fraud-related complaint for the fifth year in a row, with more than 246,000 reported incidents.[4] Although the most common type of identity theft involves consumer fraud, an increasing number of identity theft victims find they need to contact the IRS to

[1] Federal Trade Commission, *National and State Trends in Fraud & Identity Theft, January – December 2004* (Feb. 1, 2005), available at http://www.consumer.gov/idtheft/.

[2] The New York Times, Purloined Lives, available at http://nytimes.com (Mar. 17, 2005).

[3] MSNBC, LexisNexis Theft Much Worse than Thought, available at http://msnbc.msn.com/id/7475594/ (Apr. 12, 2005).

[4] Federal Trade Commission, *National and State Trends in Fraud & Identity Theft, January – December 2004* (Feb. 1, 2005), available at http://www.consumer.gov/idtheft/.

untangle their tax accounts.[5]

There are two common situations in which an identity thief can wreak havoc on a victim's tax account. In the first type of theft, the perpetrator files a fraudulent tax return early in the tax filing season using another person's name and SSN, typically seeking a large refund. Later, when the victim tries to file his or her real return, the IRS will reject it and send the taxpayer a notice that a return has already been filed under this taxpayer identification number (TIN).

The second type of tax identity theft occurs when a person not legally entitled to work in the United States purchases or "borrows" a valid SSN to obtain employment. Taxpayers who are not eligible for an SSN are required to file tax returns under an Individual Taxpayer Identification Number (ITIN).[6] However, because employers cannot accept ITINs as authorization to work, an unauthorized worker may provide a stolen SSN to an employer. When the IRS receives a Form W-2, *Wage and Tax Statement*, reflecting income earned under the SSN, the identity theft victim will receive an IRS notice indicating that he or she failed to report this income on his or her tax return.

In July 2005, the Treasury Inspector General for Tax Administration (TIGTA) released a report on the IRS response to the growing problem of identity theft.[7] The report concluded that "the IRS currently has no corporate strategy to address identity theft issues… Until the IRS develops an agency-wide strategy, it will be unable to help taxpayers and the Federal Government combat the growing threat of identity theft."[8]

In response, the IRS drafted an identity theft policy statement and in August 2005, established the Identity Theft Program Office to develop a corporate strategy. This office identified three strategic initiatives: Victim Assistance, Outreach, and Prevention.

Victim Assistance

Current IRS Procedures

Because the words "identity theft" did not appear in the Internal Revenue Manual (IRM) until recently, IRS employees had to utilize several different sections of the IRM to resolve identity theft issues. Table 1.9.1 illustrates the various types of identity theft and the IRS processes involved.

5 Federal Trade Commission, National State Trends in Fraud and Identity Theft, January-December 2004 (Feb 1, 2004), available at http://www.consumergou.idtheft.

6 ITINs are for federal tax reporting only, and are not intended to serve any other purpose.

7 Treasury Inspector General for Tax Administration, Ref. No. 2004-40043, *A Corporate Strategy Is Key to Addressing the Growing Challenge of Identity Theft* (July 2005).

8 *Id.* at 2.

TABLE 1.9.1, IRS RESPONSES TO IDENTITY THEFT

Types of ID Theft				IRS process to resolve
W-2		Tax Return		
Name	SSN[9]	Name	SSN/ITIN	
Scenario 1: Multiple Taxpayers[10]				
Stolen	Stolen	Stolen	Stolen	**Mixed Entity** – IRS able to identify true owner of SSN **Scrambled SSN** – IRS unable to identify true owner of SSN
Scenario 2: ITIN/SSN Mismatch				
Stolen	Stolen	Real	Real ITIN	**Automated Under Reporter (AUR)** – tax return filed, but some income omitted **Taxpayer Delinquency Investigation (TDI)** – no tax return filed

SCENARIO 1: MULTIPLE TAXPAYERS

Cases involving multiple taxpayers using the same TIN are classified as either a "mixed entity" case or a "scrambled SSN" case. Mixed entity procedures address situations where the IRS can identify the true owner of the common number, whereas scrambled SSN procedures cover those situations where the true owner cannot be determined.[11] IRS guidelines require Accounts Management (AM) employees to conduct preliminary research before labeling a case as a mixed entity or scrambled SSN case.[12]

If, after preliminary research, the AM employee locates the correct TIN for each taxpayer, then the IRS should follow the mixed entity procedures. The true owner of the common number will continue using the SSN, and the IRS will instruct the other taxpayer to use his or her correct TIN or be assigned a temporary Internal Revenue Service Number (IRSN).[13]

> **Example:** Taxpayer A, John Smith and Taxpayer B, Jane Smythe are both using the common number. NUMIDENT[14] indicates that the common number was assigned to John Smith and does not indicate that it was ever assigned to Jane Smythe. Research and correspondence with Taxpayer B do not provide a valid TIN for Taxpayer B, Jane Smythe. Taxpayer A, John Smith is the correct common number owner and would remain on the common number. Taxpayer B, Jane Smythe is the incorrect taxpayer and would be moved to an IRSN.[15]

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9 The common thread in tax-related identity theft is that the perpetrator uses a stolen SSN.

10 *See* IRM § 21.6.2 (Rev. 10-01-2005).

11 IRM § 21.6.2.4.2 (Rev. 10-01-2005). A "common number" is the TIN being used by both taxpayers.

12 IRM § 21.6.2.4.2(1) (Rev. 10-01-2005).

13 Internal Revenue Service numbers (IRSNs) are assigned internally for the processing of tax returns and payments only. *See* IRM § 3.13.5.23.1(1).

14 NUMIDENT stands for the Numeric Identification database, which includes information from an individual's application for a Social Security card containing the individual's name, parents' names, and date and place of birth.

15 IRM § 21.6.2.4.3.2(1) (Rev. 10-01-2005).

If the AM employee cannot determine from preliminary research the rightful owner of the common number, then the IRS must follow the scrambled SSN case procedures. The IRS sends 239C letters to both taxpayers indicating that there was a problem with their SSN and advising them to contact the SSA and request a "Social Security Administration Social Security Number Verification" printout, which the IRS will accept as proof of SSN ownership.[16]

If neither (or both) of the taxpayers responds to the 239C letter and produces proof of SSN ownership, the IRS considers the case "scrambled" and sends it to the SSA for resolution.[17] The IRS uses Form 3857, *Request for SSN Clarification*, to seek SSA assistance in unscrambling a common number. However, *the SSA has up to two years to unscramble a case and respond to the IRS!* In the meantime, the IRS freezes any refunds and puts the cases in the "two year file" to await response from the SSA.[18]

While the SSA conducts its research, the IRS assigns a temporary IRSN to taxpayers involved with the duplicate tax return situation to use when filing future returns. Because the IRSN is not a valid SSN, these taxpayers will not be allowed to claim certain credits and deductions requiring an SSN, including the refundable earned income tax credit (EITC) and dependent exemptions. This prohibition can cause extreme hardship for taxpayers who rely on these credits and deductions.

SCENARIO 2: ITIN/SSN MISMATCH

The IRS uses an automated underreporter (AUR) program to match wages reported on Form W-2, *Wage and Tax Statement*, against wages reported on tax returns.[19] If an identity thief uses a stolen SSN to obtain employment, he or she will receive a Form W-2 from the employer showing income under the stolen number. The AUR program will identify the underreported income, and the IRS will issue a CP 2000 notice to the identity theft victim proposing an assessment of additional taxes owed on the underreported wages. The victim must then contact the IRS to resolve the mismatch of wages by trying to prove that he or she was a victim of identity theft.

If this is the taxpayer's only AUR notice, and the tax liability is less than a predetermined threshold, the IRS will accept the taxpayer's written or oral statement that he or she was a victim of identity theft. However, if the taxpayer has received multiple AUR notices or the liability exceeds the predetermined threshold, the taxpayer will be required to provide proof of the identity theft.

[16] IRM § 21.6.2.4.4 (Rev. 10-01-2005).

[17] IRM § 21.6.2.4.4(12) (Rev. 10-01-2005).

[18] IRM § 21.6.2.4.4.3 (Rev. 10-01-2005); IRM § 21.6.2.4.4.7 (Rev. 10-01-2005).

[19] If there is no tax return filed for the income reported, the IRS considers it a nonfiler situation or Taxpayer Delinquency Investigation (TDI).

Unreasonable Delays in Resolving Taxpayer Accounts

In fiscal year 2005, the IRS sent 9,916 scrambled SSN cases to the SSA (up from 8,644 cases in FY 2004).[20] As mentioned earlier, scrambled SSN procedures require input from the SSA and allow up to two years for the SSA to respond to the IRS. The IRS needs to resolve the tax issues faced by victims of identity theft more quickly and efficiently. This may require coordination between the IRS and the SSA to develop a more efficient process.

Further, IRS employees are often confused as to which set of procedures to apply when assisting a victim of identity theft. Understandably, the victims would like to avoid the scrambled SSN process if possible. In some instances, the IRS used scrambled SSN procedures when it should have followed the mixed entity process. The recently revised IRM provides that "[e]very effort should be made to locate a correct TIN for both taxpayers BEFORE using scramble procedures."[21] To ensure that employees follow the revised IRM and limit the burden imposed on identity theft victims, the IRS needs to conduct appropriate training for employees who determine whether to send a case to the SSA.

Coordination within IRS Functional Groups

Like many large organizations, the IRS is composed of groups that are responsible for specific areas or functions, each with its own rules and operating procedures. For example, a victim of identity theft may have to correspond separately with employees from Automated Underreporter, Accounts Management, and Automated Collection System (ACS) to untangle his or her tax account. Requiring taxpayers to deal with these multiple points of contact results in inefficiencies for the IRS, and more importantly, places an unnecessary burden on the impacted taxpayers.

The IRS functional groups must do a better job of sharing information to make the process more efficient and taxpayer-friendly. Under current procedures, a taxpayer would be required to present different sets of documents to establish his or her identity each time he or she deals with an IRS functional group. The identity theft task force recognized the need for a uniform list of acceptable documents that can establish identity and has recommended that identity theft victims be required to provide:

- Copy of Social Security card
- Copy of document verifying current home address, such as:
  - Bank statement;
  - Lease agreement;
  - Mortgage statement; or

[20] W&I, Customer Account Services, Count of Form 3857 referrals to the Social Security Administration FY 2004 and FY 2005 updated as of November 15, 2005.

[21] IRM § 21.6.2.4.4(1) (Rev. 10-01-2005).

   - Utility bill
- Copy of document verifying identity, such as:
   - Driver's license;
   - Passport; or
   - Other federal or state government-issued ID
- Copy of document reporting incident of identity theft, such as:
   - Police report;
   - FTC Identity Theft Affidavit;[22] or
   - Correspondence with a credit bureau.

The Identity Theft Program Office should ensure that the various IRS functional groups adopt this uniform list.[23]

The IRS should also consider using an electronic indicator on its master files to mark the accounts of taxpayers who have verified that they have been victims of identity theft. Such an indicator would alert IRS personnel in other functions that this taxpayer may have special needs based on the circumstances, and relieve the taxpayer of the burden of proving again that he or she was a victim of identity theft. Use of an indicator would also raise awareness that this taxpayer may have identity theft-related issues in future filing seasons.

"Fencing Off" Wages

Employers are required to obtain proof of any prospective employee's identity and immigration status before employing that person. Undocumented workers may submit an SSN 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.

A mismatch between an ITIN on a tax return and a SSN on a Form W-2 creates two undesirable consequences. First, the identity theft victim will receive a notice from the IRS that he or she underreported income. Second, the undocumented worker will not receive credit from the SSA for wages earned. The National Taxpayer Advocate urges the IRS to develop procedures that will protect victims of identity theft from having to spend unnecessary time and effort proving that they did not earn the wages reported under their SSNs.

One possible approach would be to permit the undocumented worker to submit a substitute information document (Form 4852, *Substitute for Form W-2, Wage and Tax*

[22] In certain jurisdictions, identity theft victims will be unable to obtain a police report. In these cases, the victim is encouraged to file an identity theft affidavit with the FTC. This affidavit is available for download at http://www.consumer.gov/idtheft/pdf/affidavit.pdf.

[23] The scrambled SSN procedures were revised in October 2005 to include the list of acceptable documents. *See* IRM § 21.6.2.4.4.3, Determining if the Refund Should be Released (Rev. 10-01-2005).

Statement), listing his or her ITIN 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, the IRS can continue to process the return and issue any refund due.

Under this approach, the IRS would be able to "fence off" the wages or other income from being attributed to the victim of identity theft, thereby protecting the victim from unnecessary audits and collection actions. The SSA, after receiving notification from the IRS of the correct number (the ITIN) to associate the income, would remove the earnings credited to the identity theft victim's account and place the earnings in a suspense fund.[24]

Communication and Outreach

Because "identity theft" was not a recognized term within the IRS until recently, communication and outreach on identity theft had been non-existent. In the summer of 2005, the IRS finally developed a web page devoted to identity theft on its www.irs.gov Internet site.

However, no information on identity theft is available through more traditional communication vehicles. The IRS toll-free telephone line does not inform victims of identity theft what they should do. Key instructions and publications, including the U.S. Individual Income Tax Return (Form 1040) instruction booklet and *Your Federal Income Tax* (Publication 17), also omit any reference to identity theft. As a result, the millions of taxpayers without Internet connectivity will not have access to information on what they should do if they believe they are victims of identity theft.

Prevention

Identity theft is a growing problem nationally and internationally. It would be unrealistically optimistic to think that the IRS or any agency can successfully combat and fully eliminate this crime. However, there are steps the IRS can and should take to help curb the spread of the problem, and, at a minimum, ensure that the IRS does not contribute to the problem.

Coordination with Other Federal Agencies

The FTC maintains a database of identity theft cases to aid law enforcement agencies in their investigations. This database contains information provided voluntarily by victims, including name, address, SSN, and date of birth.[25]

The IRS is generally restricted from sharing tax return information with other federal

[24] The SSA does not maintain accounts under ITINs. When an ITIN holder uses his or her own name with the SSN on a W-2, a mismatch occurs and the earnings are placed in the suspense file.

[25] FTC, *ID Theft Complaint Input Form*, available at http://www.consumer.gov/idtheft/.

agencies.[26] However, there is no prohibition against the IRS *receiving* information from other agencies. Even if not 100 percent reliable, the information in the FTC database may still be of value to the IRS. For example, if a notation is included whenever a match appears in the FTC identity theft database, the IRS would be alerted that there is a greater probability of duplicate filing and could take proactive measures.

Protection of Taxpayer Information

As discussed above, IRC § 6103 generally prohibits the IRS from disclosing tax return information to other agencies. However, an exception allows the IRS to share returns and return information with state tax agencies, which the IRS routinely does.[27]

TIGTA recently released an audit that examined whether federal tax information was at risk while in possession of state tax agencies.[28] The report identified significant weaknesses in "physical security, user account management, access controls, audit trails, intrusion detection, and firewall systems" in each of the four state agencies reviewed.[29] These weaknesses place taxpayer information at increased risk of unauthorized use by state government employees or theft by hackers.

Prior to sharing information with any entity, the IRS should require adherence to certain security controls. It does no good for the IRS to expend resources safeguarding taxpayer information if it then allows the information to escape through the back door.

IRS COMMENTS

Recognizing that identify theft was a growing national consumer problem, this year the IRS refocused its efforts to update internal processes and to enhance interagency collaboration and coordination. We established a multi-agency working group that includes representatives from the Department of Treasury, Federal Trade Commission (FTC), the Social Security Administration (SSA), and the Department of Homeland Security (DHS) to better enable federal agencies to provide consistent information and services to assist victims from a macro level. This group serves as a role model to demonstrate the power that interagency collaboration can bring to communication, outreach activities, and process improvements.

Victim Assistance

While the percentage and number of taxpayers affected by identity theft is small, it can be very frustrating for each individual victim. Therefore, we are committed to improving processes to better assist those taxpayers that are victims of identity theft. Based on the

26 *See* IRC § 6103.

27 IRC § 6103(d).

28 Treasury Inspector General for Tax Administration, Ref. No. 2005-20005, *Increased IRS Oversight of State Agencies Is Needed to Ensure Federal Tax Information Is Protected* (September 2005).

29 *Id.*

total number of complaints in the Identity Theft Data Clearinghouse (ITDC) maintained by the FTC, fraudulent tax returns accounted for only 1.9 percent, 3.7 percent, and 3.8 percent of identity theft information misuse for calendar years 2002, 2003, and 2004, respectively.

The Scrambled SSN process was originally intended to resolve cases where the SSA issued the same SSN to two different taxpayers. The IRS collects information to enable the SSA to conduct an investigation to verify the true owner of the SSN. A joint IRS-SSA team began working in December 2004 to modernize this process and has recently completed its work. We believe that this redesigned process will dramatically reduce the time required to resolve the duplicate SSN usage before the taxpayer is required to use the temporary Internal Revenue Service number (IRSN) to file the next year's returns.

The multi-agency Scrambled SSN process reengineering includes the development of a category code and systemic control of cases that still require routing to the SSA. Unfortunately, it is not possible to distinguish a true Scrambled SSN case from an identity theft case. In the near term, the Identity Theft Program Office will periodically consolidate the information from these cases when closed. Future plans include incorporating the case tracking codes for Scrambled SSN cases in the Correspondence Imaging System.

Coordination within IRS Functional Groups

The IRS has established the Identity Theft Program Office to provide a cross-functional central point of contact for identity theft related issues. The Identity Theft Program Office has taken the lead in developing and implementing a servicewide Enterprise Strategy designed to address the issues pertaining to identity theft in the tax administration environment. The three prongs of our Enterprise Strategy are: Victim Assistance, Prevention, and Outreach.

The Enterprise Strategy is working to alleviate taxpayer burden through internal collaboration by distributing updates on the identity theft strategy via our internal intranet. These updates include information about internal process improvements, answers to frequently asked questions, and updates to the Internal Revenue Manual (IRM). Additionally, our Criminal Investigations (CI) Division applies several processes to identify and refer unlawful tax refund schemes through the Questionable Refund Program at the Fraud Detection Centers.

The IRS has closing codes in place for the majority of the taxpayer cases impacted by identity theft. These codes differentiate identity theft cases in CI, Taxpayer Advocate Service (TAS), and the Automated Underreporter (AUR) program.

The IRS will accumulate this data as well as data from other sources, such as the FTC, to determine trends. These trends will be used to develop or enhance outreach activities, communication vehicles, focus resources on enforcement initiatives, and add additional closing codes as warranted.

The IRS will continue to look for ways to collaborate both internally and externally in an effort to reduce taxpayer burden related to identity theft.

"Fencing Off" Wages

Generally, the situations described in the National Taxpayer Advocate's report involving undocumented workers using a stolen or fabricated SSN do not result in the identity theft victim receiving a notice from the IRS of underreported income. Moreover, the IRS is developing the capability to match the W-2 to the ITIN on the individual income tax return.

The IRS has developed and implemented new standards for documentation. These standards are used to validate the identity of the taxpayer, the taxpayer's address and the fact of the theft. The documentation required and used in Automated Underreporter Program and Submission Processing is consistent with documentation required by the FTC and SSA. We agree with the National Taxpayer Advocate that all IRS functions should adopt the uniform list and as part of the risk assessment we are reviewing our processes to ensure this is the case.

In addition, since many victims of identity theft are unaware of this problem until they are contacted by the IRS, we have modified our taxpayer correspondence. To this end, we have added the FTC's identity theft affidavit document to our correspondence and updated notices as an additional way for taxpayers to validate the fact of identity theft to the IRS.

Communication and Outreach

The IRS has developed a comprehensive communication strategy, which encompasses multiple outreach channels including information for the 2006 Filing Season. For example, we have launched comprehensive identity theft Web pages on both **www.irs.gov** and the IRS intranet. In addition, to educating taxpayers about identity theft prevention techniques, these sites include "alerts" on new identity theft schemes. Also, the tax year 2005 Publication 17 and the 1040 Instruction Booklet have recently been updated to incorporate guidance, which seeks to both prevent and respond to identity theft. In addition, we plan to capitalize on existing distribution channels established through Taxpayer Education and Communications (TEC) and Stakeholder Partnerships, Education & Communication (SPEC).

Protecting Taxpayers' Federal Tax Information

The IRS is currently conducting a comprehensive risk assessment designed to identify potential security vulnerabilities related to identity theft. As part of this process, we are assessing the integrity of our internal security controls as well as certain external security controls collateral to the IRS such as state agencies.

State agencies are governed by IRC § 6103 (p)(4) and as such, they are required to protect federal tax information (FTI) in accordance with the requirements of the U.S. Code as well as the policies and procedures outlined in Publication 1075, *Tax Information Security Guidelines for Federal, State and Local Agencies*. Collectively, these information security requirements include computer security (i.e. physical and logical) controls designed to protect FTI from unauthorized access, use, or disclosure. The IRS Safeguards Office performs onsite assessments of state agency facilities to evaluate the security posture and operating effectiveness of such computer security controls. Currently, adherence to the Federal Information Security Management Act (FISMA) and the applicable National Institute of Standards and Technology (NIST) standards are not mandated for the state agencies receiving FTI.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate is pleased that the IRS has recognized identity theft as a growing national problem and has established the Identity Theft Program Office. Through this office's leadership, the IRS functional groups should do a better job sharing information to make the process of resolving identity theft problems more efficient and taxpayer-friendly.

We applaud the IRS as it conducts a comprehensive risk assessment designed to identify potential security vulnerabilities related to identity theft. It is important to assess the integrity of internal security controls as well as external security controls collateral to the IRS, such as state agencies.

We also appreciate the efforts the IRS has made to participate in multi-agency working groups to address identity theft issues. Such collaborative efforts can lead to significant improvements. For example, the IRS and the Social Security Administration (SSA) were able to work together to redesign the Scrambled SSN process to significantly reduce the time necessary to resolve tax issues. To ensure that its employees understand the new procedures, the IRS should conduct appropriate training.

When an undocumented worker uses another's name and SSN to obtain employment, the IRS Automated Underreporter (AUR) unit sends a CP 2000 notice to the identity theft victim proposing an additional assessment of tax. In its response, the IRS states that an ITIN/SSN mismatch generally does not result in the victim receiving a notice from the IRS of underreported income, and suggests there is no need to develop a mechanism to "fence off" these wages. The National Taxpayer Advocate disagrees with this statement. A recent TIGTA report suggests the IRS could have saved $676,000 in the 2004 tax year if the AUR program did not have to process the 30,000 cases where an identity theft victim was sent a CP 2000 notice in an ITIN/SSN mismatch.[30] This savings does not take into account the compliance burden placed on the identity theft

[30] Treasury Inspector General for Tax Administration, Ref. No. 2004-40043, *A Corporate Strategy Is Key to Addressing the Growing Challenge of Identity Theft* (July 2005).

victim. While she commends the IRS for developing the capability to match W-2s to ITINs on a tax return, the National Taxpayer Advocate continues to urge the IRS to explore ways to fence off the wages from being attributed to a victim of identity theft.

Finally, although the National Taxpayer Advocate is pleased that the IRS is developing excellent web-based materials, we encourage it to create a simple brochure describing the tax issues that may arise from identity theft. Many identity theft victims do not have access to the internet. Moreover, IRS employees could send this brochure to taxpayers who call about this problem, and IRS outreach employees could distribute the brochure at their outreach sessions. The Taxpayer Advocate Service will work with the Identity Theft Program Office to develop such a brochure.

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations to the IRS:

- To ensure employees follow the revised IRM guidance to make every effort to locate a correct TIN for both taxpayers before using scramble procedures and limit the burden imposed on identity theft victims, the IRS should conduct appropriate training for employees who determine whether to send cases to the SSA.
- In addition, the IRS should integrate awareness of identity theft into various training modules throughout the operating divisions and functions, so all employees are sensitive to this issue and can refer taxpayers to the appropriate IRS function.
- The IRS should use an electronic indicator on its master files to mark the accounts of taxpayers who have verified that they have been victims of identity theft.
- The IRS should meet with Low Income Taxpayer Clinics regarding their experiences representing identity theft victims, who have spent unnecessary time and effort interacting with the Automated Underreporter function to untangle their tax accounts. If there is still a need for procedures that will fence-off wages and protect victims of identity theft, the IRS should develop such procedures immediately.
- The IRS should create a simple brochure, available in multiple languages, describing the tax issues that may arise from identity theft.
- Prior to sharing information with any entity, the IRS should require adherence to certain security controls.

PROBLEM

TOPIC #10 MOST SERIOUS PROBLEM: COMPLEXITY OF THE EMPLOYMENT TAX DEPOSIT SYSTEM

RESPONSIBLE OFFICIALS

Richard J. Morgante, Commissioner, Wage and Investment Division

Kevin M. Brown, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The rules and regulations governing federal employment tax deposits are overly complex, presenting significant compliance problems for employers and administrative challenges for the IRS. Recent data shows that the IRS assesses Failure To Deposit (FTD) penalties on one out of every 16 employment tax returns.[1] The large number of FTD penalties imposed each year suggests that complying with deposit requirements is unreasonably challenging for employers.

The FTD rules are so complex that even the IRS has difficulty enforcing them correctly. The IRS eventually abates more than 60 percent of the FTD penalty amount it originally assessed, and must spend considerable time and incur significant cost dealing with FTD penalty issues.[2]

ANALYSIS OF PROBLEM

Background

The Internal Revenue Code places significant responsibilities on employers for depositing, reporting, filing, and paying employment taxes. Employers are required to withhold federal and state income taxes, Medicare taxes, and Social Security taxes from their employees' wages and pay matching Medicare and Social Security taxes on behalf of their employees.[3] Employers must deposit these taxes in the prescribed manner and complete quarterly, monthly, or annual tax returns and information returns to report wages paid and taxes withheld. In fiscal year 2004, employers filed 30.4 million employment tax returns,[4] and deposited $1.4 trillion of the $2 trillion in tax revenue that the IRS collected.[5]

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1 Treasury Inspector General for Tax Administration, Ref. No. 2005-30-136, *Federal Tax Deposit Penalties Have Been Significantly Reduced, but Additional Steps Could Further Reduce Avoidable Penalty Assessments* 3-4 (September 2005).

2 IRS, *Data Book 2004*, Table 27.

3 IRC §§ 3101, 3102, 3111 – 3113, and 3121 – 3128 (Federal Insurance Contributions Act); IRC §§ 3201, 3202, 3211, 3221, 3231 - 3233 and 3241 (Railroad Retirement Tax Act); IRC §§ 3301 – 3311 (Federal Unemployment Tax Act); IRC §§ 3401 – 3407 (collection of income at source on wages); IRC §§ 3501 – 3511 (general provisions related to employment taxes); IRC § 6011 (general requirement of return, statement, or list); IRC § 6051 (receipt for employees); IRC § 6302(g) (deposits of Social Security taxes).

4 IRS, *Data Book 2004*, Table 2.

5 IRS, *Data Book 2004*, Table 1.

The IRS uses penalties to encourage voluntary compliance.[6] Indeed, penalties are an important tool in collecting the proper amount of revenue. Taxpayers who do not follow the rules for depositing employment taxes are subject to the FTD penalty.[7] The rate of taxpayer compliance with the tax laws in 2001 ranged from 83.4 percent to 85.0 percent.[8] However, when wages paid to employees are subject to withholding and third-party reporting, the compliance rate increases to almost 100 percent.[9] This statistic underscores the importance of tax withholding and collection at the source by employers. Basically, when a taxpayer knows the IRS is aware of a tax payment, the taxpayer will generally report it on his or her return.

Federal Tax Deposit Rules and Regulations

IRC § 6302 grants the Secretary of the Treasury broad authority to determine the time and method for collection of federal taxes. The Secretary has the additional authority to designate financial institutions as depositaries or financial agents to accept tax payments and establish an electronic fund transfer system for collection of depository taxes.

In general, there are two schedules for depositing employment taxes – monthly and semi-weekly.[10] An employer's deposit schedule for a calendar year is based on its employment tax reporting history during a 12-month look-back period ending on June 30 of the preceding year.[11] An employer must make monthly deposits if the aggregate amount of employment tax reported in the look-back period is $50,000 or less, and must deposit employment taxes accrued in a calendar month by the 15th day of the following month.[12]

An employer must make semi-weekly deposits if the aggregate amount reported in the look-back period is greater than $50,000. Semi-weekly depositors have three banking days in which to make deposits.[13]

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6 IRS Penalty Policy Statement (P-1-18) (August 1998).

7 The FTD penalty is assessed under IRC § 6656. See Treas. Reg. § 301.6656-1 for a complete explanation of federal tax deposit rules for withheld income taxes and taxes under FICA.

8 The estimated noncompliance rate was is in the range of 15.0 percent to 16.6 percent for tax year 2001. IRS National Headquarters Office of Research, *Tax Gap Facts and Figures*, (March 29, 2005).

9 IRS National Headquarters Office of Research, (July 2004.)

10 Treas. Reg. § 31.6302-1.

11 For example, the look-back period for calendar year 2005 is the four calendar-quarters from July 1, 2003, through June 30, 2004. *See* Treas. Reg. § 31.6302-1(b)(1).

12 Treas. Reg. § 31.6302-1(c)(1).

13 Employers with payment dates that fall on Wednesday, Thursday, or Friday must deposit the employment taxes on or before the following Wednesday. Employers with payment dates that fall on Saturday, Sunday, Monday, or Tuesday must deposit employment taxes on or before the following Friday. If any of the three weekdays following the close of a semi-weekly period is a holiday, then the employer will have an additional banking day to make the deposit. Thus, the term "semi-weekly" does not mean the taxes must be deposited twice per week, but only that the week is divided in half for the purposes of determining when a deposit is due.

The following are exceptions to the deposit rules:

- *One-Day Deposit Rule.* Employers that accrue $100,000 or more in employment taxes within a deposit period (monthly or semi-weekly) must deposit the taxes with a financial institution by the close of the next banking day.[14] A monthly depositor that makes a next-day deposit automatically becomes a semi-weekly depositor for the remainder of the calendar year and the following year.[15]
- *Safe Harbor Rule.* When an employer fails to deposit the full amount of tax due, the employer will be considered to have satisfied its deposit obligation if the amount of its shortfall does not exceed the greater of $100 or two percent of the amount of employment taxes required to be deposited.[16] The employer is required to make up the difference on or before the "shortfall make-up date."[17]
- *De Minimis Rule.* If the total accumulated employment taxes for the return period are less than $2,500 and the amount is fully deposited or remitted with a timely filed return for the return period, the amount deposited will be deemed timely deposited.[18]

How to Deposit

Generally, taxpayers do not make payments directly to the IRS but to an authorized bank depositary.[19] Taxpayers submit a Form 8109, *Federal Tax Deposit Coupon Book*, or use the Electronic Federal Tax Payment System (EFTPS).[20] Some taxpayers are mandated to use electronic fund transfer (EFT) when their total depository taxes (such as employment tax, excise tax, and corporate income tax) exceed the $200,000 threshold.[21] Once a taxpayer is required to make deposits using EFT, he or she must make all future deposits by EFT, regardless of whether the threshold is reached in each calendar year.[22]

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14 *See* IRC § 6302(g): Treas. Reg. § 31.6302-1(c)(3).

15 Treas. Reg. § 31.6302-1(b)(2)(ii).

16 Treas. Reg. § 31.6302-1(f)(i).

17 Treas. Reg. § 31.6302-1(f)(ii).

18 Treas. Reg. § 31.6302-1T(f)(4). Over the years, the IRS has increased the threshold for depositing employment taxes to simplify the rules for small businesses. In 1993, the threshold amount was $500. In June 1998, the IRS raised the threshold amount to $1,000. In 2001, the IRS raised the threshold from $1,000 to $2,500.

19 Taxpayers can mail or deliver a check to a financial institution. Taxpayers accruing less than $2,500 in tax liability (reduced by any advanced earned income credit) during the quarter can remit payment when filing the employment tax return. *See* Treas. Reg. § 31.6302-1(f)(4).

20 IRC § 6302(h).

21 *See* Treas. Reg. § 31.6302-1(h)(2)(i)(A). Taxpayers required to begin paying federal taxes electronically through EFTPS will receive notification from the IRS. The notification includes an EFTPS taxpayer enrollment form with instructions for completing the enrollment process.

22 *See* Treas. Reg. § 31.6302-1(h)(2)(C)(ii).

Failure to Deposit Penalty

When employers do not follow the rules for depositing employment taxes, they are subject to a Failure To Deposit penalty.[23] The IRS may impose the FTD penalty if a taxpayer does not deposit the correct amount of tax when due and in the appropriate manner, unless the taxpayer can show that failure is due to reasonable cause and not willful neglect.[24] The applicable penalty is two percent if the deposit is one to five days late; five percent if the deposit is six to 15 days late; 10 percent if the deposit is more than 15 days late; and 15 percent if the deposit is not paid within 10 days of the date of the notice of demand for payment.[25] Taxpayers who deposit the correct amount but use the wrong method (*e.g.*, not using the EFTPS when required to do so) are subject to a 10 percent FTD penalty.[26]

Failure to Deposit Penalty Waivers and Abatements

Under the provisions of IRC § 6656(c), the IRS may waive an FTD penalty on a person's inadvertent[27] failure to deposit any employment tax, if:

1. The person meets the requirements of IRC § 7430(c)(4(A)(ii) (relating to the net worth requirements applicable for awards of attorney's fees);
2. The failure to deposit tax occurred during the first quarter the employer was required to deposit employment taxes; or
3. It is the first deposit a taxpayer is required to make after changing the frequency of payroll deposits (*e.g.*, monthly to semi-weekly; semi-weekly to next day deposit);[28] and
4. The return for that tax was filed on or before the due date.

IRC § 6656(d) allows the IRS to abate an FTD penalty for a first-time depositor if he or she inadvertently sends the funds to the IRS instead of the appropriate depository.

IRC § 6656(e) gives taxpayers the ability to designate the allocation of payments to minimize multiple penalty assessments. For deposits made after December 31, 2001,

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23 IRC § 6656 sets forth the provisions for failure to deposit penalty.

24 IRC § 6656(a).

25 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).

26 *See* IRC §§ 6302 (h) *and* 6656 (a). In her 2004 Annual Report to Congress, the National Taxpayer Advocate proposed a legislative recommendation to amend IRC § 6656 to clarify that (1) the reasonable cause exception to the FTD penalty shall specifically apply to instances where a taxpayer has made a timely deposit, but failed to make the deposit in the prescribed manner and such failure is not due to willful neglect; and (2) in no circumstance shall the FTD penalty exceed two percent of the underpayment amount when a taxpayer has made a timely deposit, but failed to make the deposit in the prescribed manner. *See also* National Taxpayer Advocate 2001 Annual Report to Congress 222; H.R. 1528, 108th Cong. (2004).

27 The IRS will determine if a failure to deposit is inadvertent based on all the facts and circumstances.

28 Section 3304(b) of RRA 98 expanded the waiver for first-time depositors subject to a change in deposit frequency.

the IRS automatically applies deposits to the most recent period unless the taxpayer designates otherwise. The taxpayer has 90 days from the date of the penalty notice to contact the IRS to designate the application of its deposits for a specific tax period to minimize the FTD penalty.[29]

Complexity of the Federal Tax Deposit Rules and Regulations

The framework for the current federal employment tax deposit rules and regulations was borne out of an earlier set of rules and regulations that were unduly complicated and cumbersome.[30] The former deposit rules caused IRS employees significant problems, particularly with respect to the application of FTD penalties.[31] IRS employees cited complexity of the law, difficulty in computing penalties, and lag time in implementing computerized changes in computation as areas that created difficulties.[32] The IRS recognized that this level of complexity resulted in unintentional noncompliance and sought to simplify the rules and regulations in the early 1990s.[33]

Today, however, the rules and regulations governing employment tax deposits continue to present compliance and administrative challenges for employers and the IRS alike, frustrating taxpayers and draining IRS resources.

> **Example:** A small institution with 1,000 employees is responsible for filing Form 941, *Employer's Quarterly Tax Return*, and Schedule B, *Report of Tax Liability* for Semiweekly Schedule Depositors. The taxpayer has a recurring problem with FTD penalties. Each quarter, the taxpayer deposits employment taxes and files returns when due and the IRS processes the returns and assesses an FTD penalty – and each quarter, the taxpayer contacts the IRS and the IRS abates the penalty. This cycle became an exasperating exercise for the taxpayer and the IRS.
>
> A close examination of the problem revealed a long history of penalty assessments and subsequent abatements dating back to March 1990 and continuing today. TAS studied data from March 1998 to June 2005 and found that during this seven year period, the taxpayer filed 30 quarterly returns timely and paid approximately $48 million in taxes. The IRS assessed $2 million in FTD penalties in 22 of the 30 quarters, later abating all but two small FTD penalties. The reasons for the penalty assessments varied, but

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29 IRC § 6656(e)(1).

30 Under the deposit rules and regulations effective prior to January 1, 1993, employers had to monitor and accumulate employment taxes from payday to payday until one of four separate deposit rules (quarterly, month, eight-monthly, or daily) was triggered. Deposit requirements could change from month to month, depending on the amount of taxes accrued.

31 IRS Research Division, *Final Report on Penalty Desk Guide Focus Groups* (March 1991).

32 *Id.*

33 General Accounting Office (now Government Accountability Office), GAO/GGD-95-8, GAO *Reports on Revision of Federal Employment Tax Deposit Regulations* 4 (December 29, 1994).

> for 13 quarters the IRS imposed the penalty because the Schedule B was deemed invalid or missing, even though all of the employment tax deposits were made correctly.[34] In this case, the IRS never contacted the taxpayer to obtain a correct or completed Schedule B. On one return, the taxpayer listed a negative tax liability amount of less than $20 and the FTD penalty assessed was more than $100,000!

One in 16 returns filed with Form 941, *Employer's Quarterly Federal Tax Return*, is assessed an FTD penalty.[35] In fiscal year 2004, the IRS assessed 2.3 million penalties totaling $3.7 billion and abated 537,000 penalties totaling $2.3 billion.[36] The FTD penalty is the most frequently assessed penalty because of its relation to recurring payroll taxes.[37] As a result, employers and the IRS must expend a significant amount of resources trying to resolve FTD issues.[38]

TAS has repeatedly raised concerns regarding the administration of employment tax penalties. In her 2003 Annual Report to Congress, the National Taxpayer Advocate recommended the IRS assemble a team or group to perform a comprehensive analysis of the federal tax deposit system, identify problems encountered by taxpayers, and recommend measurable solutions that would lessen taxpayer burden.[39]

In response, the IRS Office of Penalty and Interest Administration (OPIA) convened a task group to address systemic assessments and abatements of FTD penalties. The group included representatives from IRS operating divisions, OPIA, and TAS. The task group identified several factors that contribute to the high assessment rates and offered six rec-

34 When taxpayers file Form 941, they may be required to file a Schedule B, *Report of Tax Liability for Semiweekly Schedule Depositors*. Taxpayers are required to list their tax liability for each day including the income tax withheld from employees paycheck and both employee and employer Medicare and social security taxes. The IRS uses the Form 941 return information, the Schedule B, and deposit records 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 Schedule B to the payment information from the taxpayers' deposits. If the Schedule B is incorrect, incomplete, or missing, the IRS will assess an FTD penalty.

35 Treasury Inspector General for Tax Administration, Ref. No. 2005-30-136, *Federal Tax Deposit Penalties Have Been Significantly Reduced, but Additional Steps Could Further Reduce Avoidable Penalty Assessments* 3-4 (September 2005).

36 IRS, *Data Book* 2004, Table 27.

37 FTD penalty issues are the highest volume and most adjusted set of transactions for the Small Business/ Self-Employed Division. IRS, *SB/SE Federal Tax Deposit Penalty Improvement Project Team Report* (October 21, 2002).

38 *Id.*

39 National Taxpayer Advocate 2003 Annual Report to Congress 204.

ommendations to improve IRS processes, taxpayer education, notices, and forms.[40]

Abatement Rate of FTD Penalties

We commend the IRS for addressing these issues, but note that FTD penalty abatement is still a problem. In fiscal year 2004, the IRS abated 23 percent of the FTD penalties and 61 percent of the dollars it originally assessed. As Table 1.10.1 shows, the number of FTD penalties assessed decreased slightly but steadily from FY 2002 to FY 2004, but the percentage of penalties abated remains unacceptably high.

TABLE 1.10.1, FTD PENALTY ASSESSMENTS AND ABATEMENTS[41]

Fiscal Year	Penalties Assessed (in thousands)	Penalties Abated (in thousands)	Abatement Rate	Dollars Assessed (in millions)	Dollars Abated (in millions)	Abatement Rate
2002	2,595	605	23%	$4,869	$3,042	62%
2003	2,409	572	24%	$4,675	$3,247	69%
2004	2,314	537	23%	$3,722	$2,271	61%

The National Taxpayer Advocate is particularly concerned that the dollar amount of penalties abated remains over 60 percent of the amount assessed. The abatement rate may even be misleadingly low, considering that in some instances, employers and payroll preparers opt to pay a disputed penalty rather than incur costs by requesting abatement.[42]

Assessing FTD penalties only to abate them later is an inefficient use of IRS resources. The IRS needs to determine why so many FTD penalties are abated, and commit to lowering the abatement rate significantly. The IRS should research the cause of FTD penalty assessments, especially where taxpayers encounter recurring problems. For example, the IRS could study this population's filing and depositing history and target those taxpayers with appropriate educational and outreach material on the FTD requirements.

[40] The task group issued a final report in March 2005 with six recommendations:
(1) Send an informational notice to taxpayers when an FTD penalty is waived because the amount at issue is below tolerance;
(2) Redesign the deposit coupon (Form 8109) to reduce errors and prevent FTD penalties;
(3) Use a better system to validate deposits and tax liabilities to reduce the number of FTD penalties based on the averaging method;
(4) Expand the Averaged Penalty Program to include overpayment and balance due assessments thereby giving significantly more employers an opportunity to resolve discrepancies before the FTD penalty is assessed;
(5) Enhance education and communications to taxpayers on the cause of the averaged FTD penalty; and
(6) Review large dollar penalty notices of $100,000 or more before the assessment is made and the notice goes out to the taxpayer.

[41] IRS, *Data Book 2002*; IRS, *Data Book 2003*; IRS, *Data Book 2004*.

[42] Department of the Treasury Office of Tax Policy, *Report to the Congress on the Penalty and Interest Provisions of the Internal Revenue Code* (Doc 1999-34492) (October 1999).

Complexity Baffles Taxpayers and IRS Employees Alike

Although the IRS mission includes helping taxpayers understand their tax responsibilities, the IRS does little to help taxpayers determine why they continually incur FTD penalties and how to avoid them.[43] In some instances, the IRS fails to inform the taxpayer when it waives an FTD penalty.[44] Educating taxpayers about these penalties can help them avoid future errors.

IRS employees are equally challenged by the procedures and computations of FTD penalty administration. In fiscal years 2004 and 2005, TAS received numerous reports of problems regarding FTD penalty calculations from TAS and IRS operating division employees. Generally, employees identified cases where taxpayers deposited withheld taxes timely but the IRS computer posted the deposits late, causing an FTD penalty to be assessed. In cases involving Form 945, *Annual Return of Withheld Federal Income Tax*, taxpayers make frequent (sometimes daily) deposits, but the computer fails to recognize the frequent payment method or otherwise misapplies the payment, resulting in an FTD penalty assessment. One employee commented that because of the amount of work involved in figuring out the correct FTD penalty and IRS computer limitations, IRS employees may be inclined to deny FTD penalty abatement requests.

Administration of Penalty Relief

Another significant problem with FTD penalty administration relates to the relief provided for cascading penalties. The IRS Restructuring and Reform Act of 1998 (RRA 98) provided relief for taxpayers by allowing them to designate the period to which a payment will be applied. Further, for deposits made after December 31, 2001, the IRS is supposed to automatically apply deposits to the most recent period unless the taxpayer designates otherwise.[45] Taxpayers have 90 days from the date of the penalty notice to contact the IRS to designate the application of its federal tax deposits for a specific tax period to minimize the FTD penalty.[46]

The IRS has experienced difficulty administering FTD penalty relief. In some instances, procedures are so unclear and confusing that IRS customer service representatives (CSRs) have adopted their own interpretation. TAS has learned of instances where CSRs have designated payments without the taxpayer's consent.[47] While this may benefit the impacted taxpayers, it exposes the difficulties and challenges the IRS faces in

[43] Treasury Inspector General for Tax Administration, Ref. No. 2005-30-136, *Federal Tax Deposit Penalties Have Been Significantly Reduced, but Additional Steps Could Further Reduce Avoidable Penalty Assessments* 3-4 (September 2005).

[44] When the IRS waives FTD penalties, it does not inform taxpayers that the amount falls below the administrative tolerance amount.

[45] Pub. L. No. 105-206, § 3304(c) (1998). The IRS states that in certain situations (five percent of all penalties assessed) the application of deposits to the most recently ended tax deposit period will not always eliminate cascading penalties and may actually lead to higher penalties than the FIFO method.

[46] IRC § 6656(e)(1).

[47] E-mail from instructor cadre on most recent payment allocation method job aid (October 13, 2005).

administering the tax law consistently and fairly.

IRS Correspondence with Taxpayers

Because employment tax rules are so confusing, the IRS must use plain language when communicating with taxpayers and provide sufficient information for taxpayers to respond properly. Dealing with penalty notices is an expensive and lengthy process for employers, especially when the notices contain unclear, incomplete, or incorrect information.[48]

CP 207 Notice

The CP 207 is one of the many confusing notices the IRS sends to taxpayers to inform them of problems with tax returns. The notice indicates that the Schedule B to Form 941 is missing, incomplete, or illegible, but does not specifically inform the taxpayer how to cure the defect, and threatens to impose a penalty if the taxpayer fails to act. The vagueness of the notice often leads to unnecessary communication between the taxpayer and the IRS.

For certain taxpayers, the IRS will assess the FTD penalty and issue the first collection notice without generating a CP 207 seeking additional information.[49] For example, employers who have a balance due or credit balance are not afforded an opportunity to resolve the matter prior to assessment. These taxpayers should be afforded the same opportunity to correct the problem before the IRS assesses FTD penalty.

CP 136 Notice

A 2002 TAS study revealed that notification of changes in deposit schedules was one of the major problems for taxpayers trying to comply with FTD requirements.[50] The IRS sends out more than 1.3 million CP 136 notices each year to inform taxpayers of changes to their deposit schedule and method of deposit for Form 941, *Employer's Quarterly Tax Return*, and each year the taxpayers, practitioners, and IRS employees encounter significant problems.[51] Taxpayers who rely on the instructions on the notice may still incur penalties for using the wrong deposit schedule. The IRS position is that it remains the taxpayer's responsibility to determine its deposit schedule and the notice is for informational purposes only.[52]

48 Treasury Department, Office of Tax Policy, *Report to Congress on Penalty and Interest Provisions of Internal Revenue Code* 222 (October 1999).

49 IRM § 20.1.4.11.5 (Rev. 09-10-1999).

50 National Taxpayer Advocate 2002 Annual Report to Congress 116.

51 IRM § 21.3.1.4.76. CP 136, Annual Notification of FTD Requirements, is issued yearly to filers of Form 941 and 941SS to advise the employer of which deposit method to use for the upcoming calendar year. In calendar years 2005, the IRS sent 1,366,003 notices advising taxpayer of their deposit schedule for 2006.

52 One SB/SE manager commented that the IRS is "telling them [taxpayers] one thing, and then holding them to another." Memo from SB/SE compliance manager (November 26, 2002), on file with TAS Office of Systemic Advocacy.

IRS Efforts to Reduce the Compliance Burden

Over the years, the IRS has attempted to reduce taxpayer burden, educate taxpayers about their responsibilities, and improve customer service. In fiscal years 2004 and 2005, the IRS launched a number of initiatives to simplify employment tax compliance. The IRS redesigned tax forms, waived FTD penalties, and offered incentives to reduce common errors that caused penalties. In fiscal year 2006, the IRS plans to introduce a new employment tax filing program to reduce burden for the smallest employers.

We applaud the efforts to improve customer service and reduce taxpayer burden, but question whether some of these initiatives will result in more complexity and taxpayer frustration.

Employers' Annual Federal Tax Program

In 2006, the IRS will launch its new Employers' Annual Federal Tax Program for employers who owe $1,000 or less in employment taxes per year. Employers who meet the criteria will be mandated to file employment tax returns annually rather than quarterly. The IRS estimates that 950,000 of the more than six million Form 941 filers will be eligible for the new program.[53] This group of employers will be required to file Form 944, Employer's Annual Federal Tax Return, and pay their annualized employment tax liability by January 31st of each year. The first Form 944 will be due January 31, 2007.

While we commend the IRS for its efforts to reduce taxpayer burden, we question whether the benefits of the program outweigh the burdens imposed on taxpayers. It is undeniable that a new program, attendant with new forms and new rules aimed at a specific subset of taxpayers, increases complexity. Affected taxpayers may not feel that the IRS has eased their employment tax paperwork burden.

The National Taxpayer Advocate is also concerned about the program's potential "yo-yo" effect, given its mandatory nature. Small business employers who straddle the $1,000 threshold for annual employment tax liability will not know with any certainty whether they must file quarterly or annually.[54] Employers who anticipate that their annual employment tax liability will exceed $1,000, or who want to opt out to electronically file Form 941, must contact the IRS by April 1st of that year to change their filing requirement from Form 944 to Form 941. Taxpayers calling after April 1st will be told they must remain Form 944 filers for the year. If this population undergoes significant "churning" (*i.e.*, alternating between quarterly and annual filing), the initiative could increase the number of FTD penalties and abatements.

Further, if an employer's total tax liability exceeds the threshold amount for annual filing, the employer is responsible for knowing whether it must make deposits in accor-

[53] SB/SE Research, *944 Program Extract Chart* (November 4, 2005).

[54] The IRS estimates that 130,000 of the 950,000 businesses eligible for annual filing will increase and outgrow the $1,000 threshold amount by the following year. SB/SE Research, *944 Program Extract Chart* (November 4, 2005).

dance with the appropriate schedule (monthly or semiweekly, if over the *de minimis* threshold of $2,500). Employers will be required to monitor this situation because they may be subject to an FTD penalty if deposits are not made appropriately.

The National Taxpayer Advocate recommends that the IRS test the Employers' Annual Federal Tax Program on a statistically valid sample of taxpayers before making these changes mandatory to determine if the benefits of taxpayer burden reduction outweigh the costs of increased complexity. The potential impact of this program on very small businesses is cause for concern because the cost and difficulty of complying with the tax code can be overwhelming for these taxpayers.[55]

Incentives to Use EFTPS

FTD penalty transactions are among the highest volume and most adjusted tax transactions for small businesses. In fiscal year 2001, the IRS issued approximately 1.2 million notices to taxpayers indicating that FTD coupons (Form 8109) were incomplete or contained errors, resulting in late or misapplied payments and an assessment of FTD penalties. The volume decreased incrementally after the IRS revised the form in 2002. By fiscal year 2005, the number of FTD penalty notices fell to approximately 826,000.

The IRS believed the number of errors would be reduced significantly if business taxpayers used the Electronic Filing and Tax Payment System (EFTPS). In fiscal year 2004, the IRS launched EFTPS Express Enrollment for New Businesses, which automatically enrolls a new business in EFTPS when it applies for an employer identification number. However, use of EFTPS did not rise as much as anticipated, possibly due to some employers (1) not having any employees at that time; (2) preferring to use the paper coupon; (3) not having access to a computer; or (4) not wanting the IRS to have access to their bank account information.[56] In FY 2004, 4.6 million businesses were enrolled in EFTPS; by end of FY 2005, 5.9 million businesses had enrolled.[57]

Redesign of Form 941 and Schedule B

The IRS recognized that employers were making a significant number of errors on Form 941, *Employer's Quarterly Tax Return*, and Schedule B, *Report of Tax Liability for Semiweekly Schedule Depositors*, in part because many did not understand the difference between semi-weekly and monthly deposit schedules.[58] In February 2005, the IRS unveiled a rewritten and redesigned form and schedule that was intended to make the instructions more clear and simplify deposit reporting by adopting the method used by most

[55] In 2000, the typical small business with fewer than 20 employees spent over $1,200 per employee to comply with tax paperwork, recordkeeping, and reporting requirements. Testimony of Thomas Sullivan, Chief Counsel for Advocacy of Small Business Administration, before the U.S. House of Representatives Committee on Small Business (April 27, 2005).

[56] E-mail from SB/SE TEC (EFTPS Group) (September 21, 2005).

[57] IRS Electronic Tax Administration, *e-Submissions Statistical Dashboard* (July 2005).

[58] IRS Form 941 Redesign Team, *A Review of Our Recommendations – IRS Form 941 Employer's Quarterly Federal Tax Return* (February 19, 2002).

employers and practitioners to calculate wages and taxes.[59]

However, initial results have been less than stellar. The processing of the first quarter filing of the newly redesigned Form 941 and Schedule B revealed a high error rate. Historically, the error rate on Form 941 returns had been around five percent. The initial error rates for the newly redesigned Form 941 and Schedule B nearly tripled (13.9 percent in the Ogden campus and 14.6 percent in the Cincinnati campus).[60]

The National Taxpayer Advocate recognizes that it is reasonable to expect more errors in the first quarter of processing a new form, but remains concerned about the increased error rate and how the changes will impact the more than 6.6 million employers required to file Form 941. She encourages the IRS to monitor the process to ensure that the redesigned Form 941 and Schedule B are working as intended. The continuing changes to the employment tax depositing, filing, and reporting process bring pressure on employers to keep up or face penalties. Ironically, for many employers, keeping up with all of the various "burden reduction" initiatives results in increased burden.

IRS COMMENTS

The IRS realizes certain taxpayers find the requirements for depositing their Federal Employment Taxes confusing and has continued its efforts to provide educational material to business taxpayers, as well as clearer instructions and publications. The IRS also has continued its efforts to reduce the burden on taxpayers where possible.

Complexity of the Federal Tax Deposit Rules & Regulations

Abatement Rate of FTD Penalties

There has been a steady decrease in the number of FTD penalties assessed/abated and the related dollars in those categories. The IRS acknowledges the high dollar abatement rate, but that was addressed by the Office of Penalties and Interest and TAS' 2004 Task Group's six recommendations. We believe that full implementation of these recommendations in 2006 and 2007 will impact the dollar abatement rate.

The IRS continues to address educational elements that can help taxpayers avoid FTD penalties, but also recognizes that some businesses choose to use withheld taxes to continue business operations. Some of those taxpayers would rather pay the penalty than deposit the funds timely.

Complexity Baffles Taxpayers and IRS Employees Alike

The IRS provided information in the 2005 Publication 15, Circular E; advising taxpayers on how to properly complete the Record of Federal Tax Liability (ROFTL), Schedule B or the Monthly Liability and of ways to avoid an averaged FTD penalty and will issue

59 *See IRS Introduces Redesigned Employment Tax Return*, Tax Notes Today, 2005 TNT 36-9, (Feb 23, 2005); *Tax Talk Today Discusses New Form 941 and Year-End*, Payroll Guide Newsletter, 2004 WL 2709175 (RIA).

60 E-mail from SB/SE Program Analyst on the results of the First Quarter Filing of Form 941 (May 17, 2005).

the information notice (CP 276) in 2007 advising taxpayers that the penalty was due but not assessed due to an administrative waiver.

IRS employees have comprehensive job aids available to properly compute an FTD penalty. Those instructions, along with IDRS Command Codes, allow employees to properly apply deposits against the correct liabilities to compute an FTD penalty.

Administration of Penalty Relief

The instructions for granting a decrease to the FTD penalty, based on the taxpayer's redesignation of deposits against liabilities, are clearly covered in the Job Aid available to all IRS employees. The instance where one site's employees were designating without taxpayer consent was addressed in an alert issued on November 4, 2005. IRS employees are provided annual training, which covers FTD penalties.

IRS Correspondence with Taxpayers

CP Notices 207 & 136

The CP Notice 136 was reviewed to improve the wording of the notice using a more "plain English" style. The opportunity to reduce the complexity of the language is somewhat limited by the federal tax deposit requirements themselves; nevertheless, the 2006 version of this notice will be more "user friendly" than previous versions reviewed by the National Taxpayer Advocate. The 2006 version will show the four look-back quarters' net taxes, so taxpayers will know what IRS records indicate and can contact the IRS regarding any discrepancies. In addition, we will work on using a more "plain English" style for the 2007 CP 207.

IRS Efforts to Reduce the Compliance Burden

Employers' Annual Federal Tax Program

In developing the Employers' Annual Federal Tax Return Program (Form 944), the IRS considered the National Taxpayer Advocate's recommendation to run a "test" of the program. After careful deliberation, the IRS decided to deploy the program for all taxpayers who owe $1,000 or less in total Employment Tax annually. Various small businesses entities are extremely pleased that the IRS is offering this program and have asked the IRS to explore raising the eligibility threshold.

As to whether a taxpayer will know whether he or she can file a 944 and when to deposit, the IRS will send notices and information to all eligible "944" taxpayers regarding their 944 filing requirement. The eligibility extract, run on November 21, 2005, identified approximately 646,000 taxpayers for the 2006 annual filing program. The IRS estimates another 150,000 new businesses may be eligible as well as an estimated 150,000 businesses that "reactivate," both of which will be advised in writing of their eligibility.

The IRS also recognizes that some businesses will grow and the taxpayer may need to make FTDs. Historic data indicates this may be six to seven percent of the population, but, similar to the filing provision for farmers (Form 943), all taxpayers need to be aware of their accruals and make FTDs as appropriate. In addition, included in the 944 regulations is a safe harbor provision for those who "grow out" of 944 and must make monthly deposits in the subsequent year, allowing them to deposit their January 2007 FTD with their February deposit by March 15, 2007, without incurring any late deposit penalty.

Incentives to Use EFTPS

The EFTPS/FTD Penalty Refund initiative brought in 87,644 taxpayers who enrolled in EFTPS, made timely EFTPS deposits for four quarters and received one-time FTD penalty abatements of $56,056,619.05 through December 8, 2005. This initiative was offered to taxpayers not required to use EFTPS and who had been penalized for making late FTDs using coupons (Form 8109) or sending payments directly to the IRS.

Redesign of Form 941 and Schedule B

In a transition year, a temporary spike in errors is normal as taxpayers and practitioners learn about any new form. By far, the most common error IRS has encountered with the redesigned Form 941 is the failure to sign the form on the appropriate signature line or to sign the form at all. This confusion results from the new signature line and other information requested of paid preparers, which was added to enhance preparer compliance.

To deal with the failure to sign the Form 941 on the correct line or at all, the IRS has made certain changes to the Form 941 that will be published for the tax year 2006. These changes include a larger signature line, a bigger "X" next to that line, and changes to the paid preparer section to ensure taxpayers who self-prepare better understand that they do not sign in this section.

IRS efforts at reducing burden are in response to requests from taxpayers, practitioners, the Small Business Administration and others, virtually all of whom have strongly endorsed the Form 941 redesign effort and the resultant redesigned Form 941. The IRS tested the redesigned form extensively using focus groups and cognitive testing. The 8th grade education standard was used for the form and its instructions and a nationally recognized "plain language" expert was employed in the redesign effort. In addition, a representative from TAS was on the redesign team and helped to craft the final product.

The IRS will continue to monitor Form 941 trends to determine that the forms are working as intended and whether the changes made to the 2006 revision of Form 941 are reducing the confusion with signatures.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the IRS for its efforts to help taxpayers comply with federal employment tax rules and regulations and avoid FTD penalties. She recognizes that the IRS is making a concerted effort to simplify employment tax forms, instructions and tax publications. Further, she appreciates the invitation extended to the Taxpayer Advocate Service to participate on cross-functional teams charged with carrying out these efforts.

Complexity of the Federal Tax Deposit Rules and Regulations

In her 2004 report, the National Taxpayer Advocate identified the confounding complexity of the tax code as the most serious problem facing taxpayers and the IRS alike.[61] The rules and regulations governing federal employment tax deposits are complex and ***do*** present significant challenges for taxpayers and the IRS. Small business taxpayers in particular struggle to keep pace with the federal employment tax requirements in a constantly changing and uncertain tax environment.

Abatement Rate of FTD Penalties

The National Taxpayer Advocate applauds the IRS's efforts to help taxpayers avoid FTD penalties. She understands that the IRS will implement recommendations from the 2004 FTD Penalty Task Group to further reduce the number of high dollar FTD penalties, but urges the IRS to do more.

The IRS should identify and study the characteristics of the population of taxpayers who experience recurring FTD penalty problems. The IRS should determine why certain taxpayers repeatedly incur these penalties and the penalties are subsequently abated. The IRS should also focus its efforts on taxpayers who repeatedly incur and pay FTD penalties. The IRS should target these groups with specific messages and implement strategies to reverse the trends including doing routine follow ups.

IRS Correspondence with Taxpayers

CP Notice 136

The rules for depositing federal employment taxes are complex and create challenges for the IRS to communicate clearly and effectively about them. The National Taxpayer Advocate acknowledges the IRS efforts to improve the Annual Notice of Federal Tax Deposit Requirements (CP 136 notice). This notice is one of a series of early intervention notices the IRS uses to help taxpayers meet their depositing requirements and avoid FTD penalties.

Unfortunately, each year there are problems with the notice. For example, the CP 136 notices sent out in late 2005 contained look-back information for the 2006 tax year, but contained references to the 2005 tax year. In 2004, the notices included incomplete tax

[61] National Taxpayer Advocate 2004 Annual Report to Congress 2.

liability information, which was used to determine a taxpayer's deposit schedule. We urge the IRS to make every effort to ensure the correct information is sent out to taxpayers so that it can avoid costly errors that impact both employers and the IRS alike.

CP Notice 207

We strongly believe the IRS can improve the clarity of the notice, but agree with the agency's position that the opportunity to reduce the complexity of the language is somewhat limited by the federal tax deposit requirements. We applaud the decision to use a "plain English" style for the 2007 version of the notice.

IRS Efforts to Reduce the Compliance Burden

Employers' Annual Federal Tax Program

We are disappointed by the IRS decision to implement this new program without sufficient testing. This is a major change for nearly one million of the very smallest businesses and contains some risk of increasing payment noncompliance. The Taxpayer Advocate Service will monitor the implementation of this program to ensure that the risks are minimized.

Incentives to Use EFTPS

The EFTPS/FTD Penalty Refund initiative is an innovative approach to increasing EFTPS enrollment, resulting in the abatement of $56 million in FTD penalties. The National Taxpayer Advocate supports the IRS's efforts to increase use of EFTPS. However, she remains concerned about another initiative – EFTPS Express Enrollment for New Businesses. New businesses are not activating their EFTPS accounts as expected. And some taxpayers continue to prefer using the paper coupon. Conducting focus groups with these taxpayers and their preparers may help to identify new incentives to move those employers to EFTPS. TAS will be pleased to assist the IRS in this research.

Redesign of Form 941 and Schedule B

Forms are a bridge between taxpayers and the tax law, enabling taxpayers to comply in a consistent manner.[62] The National Taxpayer Advocate commend the IRS for simplifying the Form 941 and Schedule B, Report of Tax Liability for Semiweekly Schedule Depositors. We recognize that a temporary spike in errors is to be expected in a transition year as taxpayers and practitioners learn about the new form. We are especially pleased that the IRS will continue to monitor Form 941 trends to determine that the forms are working as intended and whether the changes made to the 2006 revision of Form 941 are reducing the confusion with signatures.

[62] Written Testimony of Commissioner of Internal Revenue Service Mark Everson before the Committee on Government Reform's Subcommittee on Regulatory Affairs, United States House of Representatives Hearing on Paperwork Burden 2 (May 25, 2005).

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations to the IRS to improve its administration of the employment tax deposit process:

- The IRS should conduct research to determine why so many FTD penalties are abated, and commit to lowering the abatement rate significantly.
- The IRS should use plain language when communicating with taxpayers and provide sufficient information for taxpayers to respond properly.
- The IRS should test the Employers' Annual Federal Tax Program on a statistically valid sample of taxpayers before making these changes mandatory to determine if the benefits of taxpayer burden reduction outweigh the costs of increased complexity.
- The IRS should monitor the compliance rates of taxpayers using the redesigned Form 941 and Schedule B to determine if the improvements are working as intended.

PROBLEM

TOPIC #11 MOST SERIOUS PROBLEM: AUTOMATED COLLECTION SYSTEM LEVY RELEASES

RESPONSIBLE OFFICIALS

Richard J. Morgante, Commissioner, Wage & Investment Division

Kevin Brown, Commissioner, Small Business/Self-Employed Division

DEFINTION OF PROBLEM

The IRS Automated Collection System (ACS) is a part of the IRS collection process that uses automated systems to collect from delinquent taxpayers via collection notices and in some cases by levies on taxpayer assets.[1] The ACS sites are supported by collection representatives who communicate with taxpayers by telephone. When the IRS and the taxpayer agree to certain collection alternatives, the Internal Revenue Code and Treasury Regulations require prompt release of any existing levies on taxpayers' property.[2] However, in too many cases, levy releases do not occur promptly or do not occur at all. This situation results in additional levies, which may constitute violations of the law, but certainly constitute violations of the agreements reached with taxpayers. Additionally, in too many cases, the IRS does not release property that has been levied upon in violation of the law, or in other cases, the property is returned only after the taxpayers surmount significant procedural hurdles.

ANALSYSIS OF PROBLEM

Levies upon taxpayers who have entered into installment agreements or whose accounts have been designated as currently not collectible because of economic hardship are prohibited by the Internal Revenue Code.[3] In a 2004 survey of Local Taxpayer Advocates across the country, inappropriate levies and untimely levy releases by the ACS were consistently ranked among the top most serious problems affecting taxpayers.[4]

Inappropriate levies can have a harmful effect on the IRS's efforts to bring noncompliant taxpayers back into compliance. For example, taxpayers who have entered into

[1] Treasury Inspector General for Tax Administration, Ref. No. 2002-10-078, *The Internal Revenue Service's Levy Process Can be Improved to Ensure Compliance with the Internal Revenue Code* 2 (March 2002).

[2] IRC § 6343(a) and accompanying Treasury Regulation § 301.6343-1(a) require levies to be promptly released if the taxpayer enters into an installment agreement with the IRS or if the IRS determines that the taxpayer is suffering a hardship; IRC § 6343(e) provides that the IRS must release levies as soon as practicable when it determines that an account is not collectible.

[3] IRC § 6331(k)(2) (prohibiting levies while proposed installment agreements are under consideration and after installment agreements have been accepted); IRC § 6343(a)(1)(D) (requiring release of levy when taxpayer is experiencing hardship); and IRC § 6343(e) (requiring release of levy when taxpayer's account is determined to be currently not collectible).

[4] LTAs are part of the Office of the Taxpayer Advocate (also known as the Taxpayer Advocate Service) provided for in IRC § 7803(c), which requires at least one LTA for each state. In developing the Most Serious Problems discussed throughout this Annual Report to Congress, the LTAs were asked to report on the top five most serious problems experienced by the taxpayers in their states. In ranking various issues, LTAs considered the number of taxpayers affected and the degree of severity of the issue. Levy releases were consistently ranked among the top five most serious problems.

installment agreements with the IRS have done so in reliance upon the representation that existing continuous levies will be released and no new levies shall occur while the installment agreement is in place. When erroneous levies occur, the IRS fails to honor its representations to the taxpayer. Likewise, when the IRS agrees to designate an account as currently not collectible (CNC) because of the taxpayer's economic hardship, it is acknowledging that the taxpayer cannot satisfy his or her basic living conditions.[5] When erroneous levies occur, the IRS is exacerbating the problems of taxpayers in varying degrees of financial distress. In each instance, taxpayers may decide that because the IRS has not honored the terms of the agreement, the taxpayer need not.

Our analysis addresses three issues with respect to levy releases in the ACS:[6]

- Levies not released that should be released;
- Levies not released in a timely fashion; and
- Wrongfully levied property not returned.

The problems discussed herein reflect a failure to remove existing levies and do not reflect an intentional act on the part of the IRS to impose an unlawful levy. In some cases, the failure to release existing levies is a function of an automated ACS environment, which fails to recognize that an alternative arrangement was worked out with the taxpayer. In the case of untimely levy releases, the failure to release levies is sometimes a function of IRS procedures, which do not place the burden on ACS employees to expedite levy releases, unless specifically requested to do so by the taxpayer.[7] With respect to returning inappropriately levied funds, however, TAS has identified numerous cases where the ACS representatives have refused to return inappropriately levied upon funds.

Legal Requirements on Levy Releases and Return of Levy Proceeds

Installment Agreements

Installment agreements provide taxpayers the ability to make periodic payments to resolve outstanding tax liabilities.[8] The IRS is prohibited from levying during certain times, including:

5 Treas. Reg. § 301.6343-1(b)(4)(i)-(iii).

6 For additional problems related to levies and levy releases in this report, *see* Most Serious Problem, *Levies On Social Security Payments, supra*; and Additional Legislative Recommendation, *Social Security Levies, infra.*

7 IRM § 5.19.4.4.12.5.

8 There are several types of installment agreements. For example, IRC § 6159(c) provides for a **guaranteed installment agreement** if the liability is under $10,000, the taxpayer agrees to pay the liability within 3 years, the taxpayer is unable to pay the liability in full, and within the last 5 years, the taxpayer has filed tax returns, paid all other Federal tax obligations and not entered into any other installment agreements. The IRS also provides for a **streamlined installment agreement** if the liability is under $25,000, the taxpayer cannot afford to immediately full-pay the liability (no in-depth verification of the taxpayer's financial circumstances or IRS manager approval is required), the liability will be fully paid within 60 months, and all of the taxpayer's returns have been filed. IRM § 5.14.5.2. Taxpayers can also qualify for **installment agreements above $25,000**; however, the IRS requires verification of the taxpayer's financial situation, as well as managerial approval for such agreements. IRM § 5.14.1.2.

- The period when a proposed installment agreement is pending;[9]
- The period when an accepted installment agreement is in place;[10]
- For 30 days following the rejection of an installment agreement;[11]
- For 30 days immediately following the termination of an installment agreement;[12] and
- The period while the matter is pending before the Office of Appeals. If the IRS rejects a proposed installment agreement and the taxpayer files a timely appeal to the Office of Appeals, the IRS cannot levy during the period while the matter is pending before the Office of Appeals.[13]

When a taxpayer and the IRS enter into an installment agreement, IRC § 6343(a)(1)(C) and accompanying regulations require that all levies be *promptly* released.[14] Thus, for example, if the IRS had a wage garnishment on a taxpayer's salary prior to the submission of a proposed installment agreement, the levy must be promptly released when the installment agreement is accepted by the IRS.

Accounts Designated as "Currently Not Collectible"

If the IRS determines that an account is currently not collectible (CNC), the IRS must promptly release the levy if it is causing an economic hardship for the taxpayer.[15] In order to establish hardship for purposes of obtaining a CNC account designation, the taxpayer must demonstrate an inability to meet his or her basic living expenses.[16]

Return of Levied Upon Property

The IRS has the authority to return levied property to taxpayers under IRC § 6343(d)(2)(A)-(D) in certain situations where:

- The levy was premature or otherwise not in accordance with IRS administrative procedures;
- The taxpayer has entered into an agreement (unless the agreement provides otherwise);

[9] IRC § 6331(k)(2)(A). An installment agreement is "pending" with the IRS when accepted for processing and remains pending until the IRS accepts the proposal or rejects the proposal or is voluntarily withdrawn by the taxpayer. Treas. Reg. § 301.6331-4(a).

[10] IRC § 6331(k)(2)(C).

[11] IRC § 6331(k)(2)(B).

[12] IRC § 6331(k)(2)(D).

[13] *Id.*

[14] Treas. Reg. § 301.6343-1(b)(3) provides that the IRS is not required to release the levy if the IRS determines that the collection of the tax is in jeopardy.

[15] IRC § 6343(a)(1)(D).

[16] *See* Treas. Reg. § 301.6343-1(b)(4)(i)-(iii) definition of economic hardship. The IRS has also established other non-hardship criteria where it may be appropriate to designate an account as CNC including taxes owed by inactive businesses with no assets or certain bankruptcies where the IRS is unlikely to receive further proceeds from the bankruptcy estate. IRM § 5.16.1.1.

- The return of such property will facilitate the collection of the tax liability; or
- The return of the property would be in the best interest of the taxpayer (as determined by the National Taxpayer Advocate) and the United States.

These circumstances give the IRS the discretion to return property under certain circumstances. However, Treasury Regulations provide that it shall be deemed in the best interest of the United States and the taxpayer to return levied property whenever the levy is in violation of the law.[17] The regulation provides examples of violations of the law that would necessitate return of levied property, including levies made while an installment agreement is being considered, after an installment agreement has been accepted and is in effect, during the 30 days following rejection of a proposed installment agreement (and while the proposed rejection is on appeal if the appeal is timely filed with the Office of Appeals) and for 30 days after an installment agreement is terminated (and while the proposed termination is on appeal if the appeal is timely filed with the Office of Appeals).[18]

Automated Collection System (ACS)

The ACS collects delinquent taxes through a combination of human and automated processes. The ACS is only one component of the IRS collection process. Generally, the IRS collection process is comprised of three stages: the notice stream, the ACS, and the Collection Field Function (CFF). In the notice stream, the IRS typically sends a series of collection notices to taxpayers – four notices to individual taxpayers and two to business taxpayers. If the taxpayer does not arrange to make payments during the notice stream, the account is assigned to either the ACS or to the CFF, depending on the type of tax and the taxpayer. The ACS typically handles most individual taxpayer accounts.

The ACS systems are programmed to search IRS databases for levy sources so that the IRS will be in a position to take levy action if the taxpayer does not make an effort to contact the IRS.[19] Collection representatives are also trained to seek levy sources from taxpayers with whom they are in contact. When taxpayers exhaust or fail to make a timely request of their Collection Due Process rights, the IRS will levy on taxpayers' income or other assets. These levies can take many forms, including one-time bank account levies or continuous levies upon a taxpayer's income until the tax liability is satisfied.[20] When taxpayers realize their assets are being levied, they often contact the ACS

[17] Treas. Reg. § 301.6343-3(d).

[18] *Id.*

[19] Before a levy action is taken, the IRS must send a notice of its intent to levy to the taxpayer. IRC § 6331(d). The IRS must also provide to the taxpayer notice of the taxpayer's right to a Collection Due Process hearing with the IRS Office of Appeals in which taxpayer can raise a number of issues, including collection alternatives such as installment agreements or offers in compromise. IRC § 6330(c)(2).

[20] IRC § 6331(h).

to try to establish a collection alternative so that the levy can be released.[21]

Taxpayers encounter two related problems with levy releases. The first situation involves levy releases that are not processed at all and would not be released but for the persistence of the taxpayer or the intervention of TAS or some other function in the IRS. The other situation involves levy releases that are systemically processed in an untimely fashion.

Levies Not Released

When the IRS is determining whether to designate an account as CNC, the ACS employee typically takes the taxpayer's financial information over the phone. If the taxpayer provides sufficient information to demonstrate an economic hardship, the collection representative is authorized to designate the account as CNC while talking with the taxpayer. Levy releases in CNC hardship cases are supposed to result in an automatic levy release. However, the automatic levy release involves a week-long processing cycle. This one-week delay can result in additional levies on the taxpayer's wages or other property; thus, collection representatives are authorized to input manual levy releases to speed the levy release process.

As the collection representative is processing the CNC request, the ACS systems are programmed to prompt the representative with the query: "ANY LEVY RELEASES NEEDED?" This prompt was installed into IRS data systems for CNC cases as a result of a 2002 audit by the Treasury Inspector General for Tax Administration (TIGTA), which determined that levies were not being promptly released in economic hardship cases.[22] While the IRS systems are designed so that levies are released automatically when a CNC hardship case is entered into the system, the levy release prompt acts as an extra safeguard to ensure levies are always released promptly in such cases.

A review of the Taxpayer Advocate Service's case inventory system (known as the Taxpayer Advocate Management Inventory System or "TAMIS") demonstrates that the number of inappropriate levies on CNC accounts has declined since 2003 when the levy prompt was added for economic hardship cases. However, a recent example provided by a Local Taxpayer Advocate demonstrates that taxpayers still encounter situations when the ACS fails to process levy releases for taxpayers encountering economic hardships.

> **Example:** A military retiree called the ACS throughout 2003 and 2004 in response to various levies on his financial accounts related to an unpaid assessment. As the ACS account history demonstrated, the retiree was initially arguing that the balance of the liability was incorrect because the IRS failed to apply a prior year's overpayment to the liability of the tax year in question. After other levy sources had been exhausted, the IRS began levy-

[21] IRM § 5.19.4.4.12(2) provides that in addition to collecting delinquent taxes, levies are also a tool to compel the taxpayer to contact the IRS to resolve the liability.

[22] Treasury Inspector General for Tax Administration, Ref. No. 2002-10-078, *The Internal Revenue Service's Levy Process Can be Improved to Ensure Compliance with the Internal Revenue Code* (March 29, 2002).

ing the retiree's pension. The taxpayer then argued that he could no longer afford basic living expenses and was on the verge of bankruptcy. He also continued to fax documents to the ACS supporting his argument that the account balance was incorrect. In December 2004, the ACS representative told the taxpayer that the account was "submitted for currently not collectible." Although the account was designated as CNC, the levy on the retiree's pension was not released. After the taxpayer complained to the ACS, he was referred to TAS. When TAS intervened on behalf of the taxpayer, the ACS agreed that levy release procedures had not been followed. In March 2005, the IRS faxed and mailed a levy release to the retirement system. The ACS also refunded the payments that were levied over the three months.

The above case demonstrates there are circumstances when the levy release prompt and the systemic levy release system are insufficient protection for taxpayers. While it was not possible in this instance to determine why the system did not work to release the levy on the taxpayer's assets, it is clear this taxpayer had been advancing the same fact intensive argument for over one and one-half years, yet the case was only referred to TAS when inappropriate levies were made on the taxpayer's retirement funds.[23] This example suggests cases involving fact intensive disputes that need close scrutiny are ill-suited for the high volume automated environment of the ACS and should be referred to a special unit or to TAS sooner.

There are similarities in the ACS process for evaluating accounts for CNC and for installment agreements, but there are also important differences. The processes are similar in that ACS collection representatives can enter into installment agreements with taxpayers over the phone provided the taxpayer has his or her financial information available. Certain installment agreements do not require managerial approval, and can therefore be processed relatively quickly.[24] Agreements falling outside the guaranteed and streamlined installment agreements require managerial approval.[25]

Unlike CNC cases, however, processing levy releases for installment agreements requires the collection representative to manually input the levy release code. Thus, the likelihood of human error increases the chances of levies not being released. Moreover, the levy release prompt that has reduced inappropriate levies for CNC taxpayers suffering economic hardship is not available for collection representatives who are placing taxpayers into installment agreements. Consequently, the problems observed with CNC levy releases at the time of the 2002 ACS audit by the Treasury Inspector General for Tax Administration are still being experienced with installment agreements. Installment

[23] The taxpayer met several TAS case criteria in that he was suffering a significant hardship (criteria 1) and had experienced a delay of more than 30 calendar days to resolve a tax account problem (criteria 5).

[24] *See* description of Guaranteed and Streamlined Installment Agreements, *infra*.

[25] IRM § 5.14.1.2.

agreements are processed through the IRS Integrated Data Retrieval System (IDRS) rather than through the ACS system. Thus, the levy prompt added to the ACS system in 2003 does not facilitate levy releases in conjunction with installment agreements.

ACS sites communicate with millions of taxpayers annually, and not all taxpayers who call the IRS are attempting to enter into collection alternatives. Of those taxpayers who are trying to obtain collection alternatives, not all will seek to release a continuous levy. Both the IDRS and ACS systems need a systemic warning signal that will cause ACS collection representatives to assess whether a taxpayer who is entering into an installment agreement is experiencing an ongoing levy that needs to be released.

Local Taxpayer Advocates report numerous cases where the ACS did not release the levy according to procedures when a taxpayer entered into an installment agreement. The following example illustrates how the different parts of the IRS collection system do not effectively communicate to timely release ACS levies.

> **Example:** The ACS imposed a continuous levy on the taxpayer's wages. The taxpayer's attorney contacted the IRS through the Internet Electronic Accounts Resolution system (EAR) to propose an installment agreement. The IRS notified the taxpayer's attorney through EAR the installment was accepted. A week later, the attorney contacted EAR, indicating the levy was not released. By e-mail, EAR replied that a response from the IRS Collection function would be sent in 30 days. A month later, the IRS had still not released the levy and the taxpayer's attorney complained the levy and installment agreement had almost fully consumed the taxpayer's paycheck. EAR responded that it did not have the authority to release levies and the ACS was responsible. EAR also referred the case to TAS, which obtained a levy release by contacting the ACS.

The case demonstrates that different components of the IRS collection system do not effectively communicate information about levy releases and do not always work with the required sense of urgency to release existing levies for taxpayers who have entered into installment agreements.

Levies Not Released Timely

The problem most frequently reported to TAS by taxpayers regarding levy releases involves the processing time. The Internal Revenue Code and accompanying Treasury Regulations require the IRS to release levies promptly when a taxpayer is suffering an economic hardship or when a taxpayer enters into an installment agreement.[26] Although the regulation does not define the term *promptly*, its ordinary meaning is "at once, immediately."[27]

[26] *See* IRC § 6343(a) and Treas. Reg. § 301.6343-1(a).

[27] *Webster's Third New International Dictionary*, 1816 (1991).

To begin the levy release process, a collection representative must input the levy release code on an account. If normal procedures are followed, the levy will not actually be released on IRS data systems until the close of the next processing cycle, *i.e.* one week. All levy releases input during the cycle are released at the end of the cycle. IRS procedures provide levy releases will then be mailed to the levy source, *i.e.* the employer or other source of taxpayer income.[28] Thus, standard levy release procedures can routinely take 10 days, including mailing time.

Levy release procedures may be expedited if a faster release is necessary to prevent over collection or to relieve hardship.[29] In that case, a manual levy release is processed by the collection representative and is faxed to the levy source. However, both the Wage and Investment Operating Division (W&I) and the Small Business/Self-Employed Operating Division (SB/SE) interpret this exception to mean the taxpayer must suggest the expedited procedures and prove the expedited relief is warranted. The predictable result is that taxpayers who will be subject to additional interim levies do not know enough to ask for the expedited procedures and others who ask for the expedited procedure will be turned down because the collection representative does not believe expedited procedures are warranted.

> **Example:** The IRS notified an employer that a wage levy was being placed on one of its employees for a delinquent tax obligation. The employee-taxpayer immediately contacted the ACS and established an installment agreement. The IRS told the taxpayer that it would release the levy immediately. The levy was not released until three weeks later, by which time three additional levies were made on the taxpayer's wages. The taxpayer was referred to TAS, which provided levy release assistance and sought the return of some of the levied funds. The ACS representative disputed that there was any error on the part of the IRS and initially refused to return any funds. The ACS case history reflects the following notation by the collection representative: "The taxpayer did not offer a fax number for the levy source and call site is not responsible to locate one. Gave ATAO IRM Ref 5.19.4.4.12(g) that also tells them we have the discretion to keep levy payments already due us." Ultimately, the collection manager agreed to return the levied funds from the date of the installment agreement.

In the example above, the collection representative appears to have interpreted the obligation to release levies promptly as the obligation to enter the levy release code promptly, rather than to ensure that the levy is actually released. The result was that the levy was not released until three weeks later. However, Internal Revenue Code § 6343(a) and accompanying regulations require that the taxpayer be relieved of the burden of additional levies if the taxpayer is suffering an economic hardship or has come forward

[28] IRM § 5.19.4.4.12(4).

[29] IRM § 5.19.4.4.12(5).

to enter into an installment agreement.[30] In cases other than an economic hardship where the IRS and taxpayer have agreed that the tax is not collectible, the IRS must release its levies "as soon as practicable" pursuant to IRC § 6343(e), such that the IRS must not employ any delay in the levy release process.[31]

In another example provided by a Local Taxpayer Advocate, the taxpayer and ACS entered into an installment agreement that called for the IRS to release a bank account levy.[32] The ACS representative insisted on mailing a levy release to a bank rather than faxing it and refused to fax a copy of the release to the taxpayer. The result was the levy release arrived at the bank after the funds in the account were sent to the IRS.

These cases suggest the ACS needs to conduct more training on IRC § 6343(a) with ACS employees. Additionally, the ACS should reverse the burden related to expedited procedures and presume taxpayers suffering economic hardships or entering into installment agreements need the levy released before their next paycheck is issued. The ACS should require its representatives to inform taxpayers about expedited procedures and ask for a fax number for the levy source. With the advent of fax machines, expediting levy releases when the taxpayer is suffering an economic hardship or has entered into an installment agreement should not be viewed as an excessive burden for the IRS. In fact, this taxpayer-friendly approach encourages compliance.

Return of Levy Proceeds

Another problem facing taxpayers working with the ACS is that in some cases, the IRS refuses to return funds levied in the interim period between the dates when a collection agreement is agreed to and when the levy source receives the levy release. The IRS's internal procedures previously acknowledged the systemic release process may be too slow to prevent over-collection and encouraged collection staff to take steps to prevent this

30 *See* IRC § 6343(a) and Treas. Reg. § 301.6343-1(a).

31 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 150-206, § 3432 (1998)(now codified in IRC § 6343(e), provides that "In the case of a levy on the salary or wages payable to or received by the taxpayer, upon agreement with the taxpayer that the tax is not collectible, the Secretary shall release such levy as soon as practicable." However, earlier versions of the provision required "immediate" release of such levies. See S. Rep. No.105-174. In arriving at the "as soon as practicable" language, the Conference Committee Report notes that the IRS "is not to intentionally delay until after one wage payment has been made and levied upon before releasing the levy." *See also* IRS *Restructuring and Reform Act of 1998*, Hearing Before the Senate Finance Committee, 105th Cong., 2nd Sess. (Feb. 5, 1998) (Statement of Nina E. Olson, then Executive Director of the Community Tax Law Project) testifying:

> It has never been adequately explained to me why, when the IRS is given proof of a taxpayer's inability to pay the tax, the IRS will not release a previously filed wage levy until one wage payment is levied upon. This is the case where the Service and the taxpayer agree that the taxpayer is "currently not collectible" and yet the Service still collects one period's wage levy before releasing the levy. The taxpayer should not be forced to seek a Taxpayer Assistance Order if all the parties agree that the taxpayer cannot afford to pay any amount toward the tax.

32 When a bank is served an account levy, it cannot release the funds until 21 days after service of the levy. IRC § 6332(c). In the case described above, the taxpayer and the IRS agreed to an installment agreement before the expiration of the 21 days and the terms of the installment agreement provided for release of the levy on the bank account.

situation. However, this section of the Internal Revenue Manual (IRM) was deleted in 2003.[33] In one recent TAS case, an ACS representative cited the deletion of IRM § 5.19.4.4.14 as a basis to retain funds levied during the interim period when an installment agreement was entered into and when the levy source received the levy release.

The IRS's internal procedures for permitting return of levied property follow IRC § 6343(d). That is, the IRM instructs the employee to return levy proceeds where the levy is premature, IRS procedures were not followed, an installment agreement is made for a liability included on the levy, returning the payment facilitates collection, or where returning the property is in the best interest of the taxpayer (as determined by the National Taxpayer Advocate) and the government.[34] The Treasury Regulations provide that it is in the best interests of the taxpayer and the IRS to return levy proceeds where there has been a violation of the law.[35] The IRS does not always release levies "promptly" (as is required by IRC § 6343(a)(1)(C) in cases where taxpayers enter into installment agreements or are suffering economic hardships) or "as soon as practicable" (as is required by IRC § 6343(e) in cases where the taxpayer and the IRS agree that the tax is not collectible). As the example below demonstrates, when the IRS levies on additional funds after agreeing to a levy release, it does not always readily agree to return the proceeds, even when it appears not to have satisfied the timeliness standard.

> **Example:** A taxpayer with a continuous levy on wages contacted the ACS to indicate that she had been served with an eviction notice from her apartment for not paying her rent. The ACS agreed to place the account in CNC status and mailed the levy release to the employer. The taxpayer called three weeks later to complain that the employer had only just received the levy release and asked for a refund of the funds levied after the date on which CNC status was granted. The ACS refused, indicating that hardship was not a basis to return levied property and that returning the money was not in the interest of the government because the government was not likely to receive any further payments on the account. The taxpayer came to TAS. Eventually, the collection manager agreed to return the funds.

The ACS collection representative in the example did not appreciate that the timeliness of a levy release weighs upon the decision of whether to return levied property. The

[33] IRM § 5.19.4.4.14(2).

[34] IRM § 5.11.2.3.2(1).

[35] Treas. Reg. § 301.6343-3(d); *but see* IRM 5.11.2.3.2(1) which provides:

> Except for a levy in violation of the law (see IRM 5.11.2.3.1(3)), there are no rigid rules for deciding whether to return a levy payment.

IRM 5.11.2.3.1(3) then provides:

> The taxpayer can file a claim for the return of property up to nine months after the levy. Claims made after that point cannot be considered.

Although the cross reference to IRM 5.11.2.3.1(3) appears to indicate that the IRM will explain what constitutes a violation of the law, no such explanation is provided. The IRM does not inform IRS personnel that the timeliness of a levy release should weigh upon the decision of whether to return levied property.

taxpayer was suffering an economic hardship because she could not meet her basic living expenses.[36] Thus, the IRS was required to release the levy promptly, but the release was not accomplished until three weeks later.[37] This case further demonstrates that ACS employees need better training and guidance about levy releases and the return of levied property. Regardless of whether the standard for a particular levy release is "promptly" (as is the standard for installment agreements and taxpayers facing an economic hardship) or "as soon as practicable" (as is the standard when the IRS and the taxpayer agree that the debt is not collectible), the IRS should not obstruct a taxpayer's efforts to have erroneously levied funds returned when the IRS has agreed that no more levies should occur and it is unable satisfy the timeliness standards to which it is subject.

CONCLUSION

It is essential that the IRS acts to release levies in a timely fashion when taxpayers come forward to resolve their outstanding liabilities and either enter into installment agreements or demonstrate they are suffering economic hardships. The IRS can improve its levy release response by embedding a levy release warning for installment agreements on the IDRS. Additionally, the IRS should utilize expedited levy release procedures where possible so that the IRS does not take additional funds from taxpayers after agreeing that no further levies will occur. Finally, the IRS should provide additional training to ACS collection representatives to sensitize them to the importance of returning property levied upon in violation of the law. Although it may be a subjective judgment as to whether a levy release was "prompt" as the law requires, the IRS should err on the side of returning levied proceeds in cases where it has agreed that no further levies are warranted. As evidenced by examples in this Most Serious Problem, the IRS's failure to communicate levy release information ends up costing the IRS valuable collection, managerial, and TAS resources, not to mention imposing a significant burden on taxpayers who are trying to be compliant.

IRS COMMENTS

As recognized by the National Taxpayer Advocate, it is essential that the IRS release levies in a timely fashion when taxpayers either enter into installment agreements or demonstrate that they are suffering economic hardships. The IRS has multiple programming and procedural processes in place to address levy releases appropriately as required by the law.

Levies Not Released

The National Taxpayer Advocate's report notes that levy releases in currently not collectible (CNC) hardship cases should result in an automatic levy release. When the IRS

[36] Treas. Reg. § 301.6343-(1)(b)(4).

[37] Treas. Reg. § 301.6343-1(a).

determines an account is currently not collectible, the Automated Collection System (ACS) takes the appropriate actions, which can occur systemically or manually, to ensure prompt release of existing levies.

While the CNC levy release is an automatic prompt, levy releases for installment agreements require manual input. However, installment agreements are currently input directly through IDRS, so there is nothing on the ACS system at this time that would trigger a reminder to check for needed levy releases. As suggested by the Advocate, we will determine the feasibility of adding a systemic prompt for installment agreements.

Levies Not Released Timely

The Service is required to release levies promptly when a taxpayer is experiencing economic hardship. When a taxpayer enters into an installment agreement, if the terms of the agreement include partial payment from a wage or bank levy that is considered an initial payment towards the liability, the levy will be released through normal processing, unless economic hardship is determined.

ACS employees have the authority to provide a faxed copy of a levy release to the taxpayer and employer if circumstances warrant it, e.g., release needed to prevent over-collection or relieve hardship. Employees are aware of these procedures and make use of its capability when appropriate. W&I campuses have dedicated clerical staff to ensure that fax levy releases are provided when needed. However, if the taxpayer cannot furnish a fax number or contact number, the only option available is to mail the levy release.

To decrease the timeframe of releasing levies timely, a system enhancement will be implemented January 2006 that will update the levy release with the most current levy source address from the electronic levy system. This will prevent delays in levy releases reaching the most current third-party source.

The IRS has worked diligently to put processes and programming in place to reduce the instances of full paid accounts that continue to receive payments from the source:

- Effective January 2005, our systems were updated to generate transcripts for ACS Support (ACSS) when accounts are full paid and levy payments are received. Employees use Remittance Transaction Research to identify the source of the payment and send levy releases.
- We are working in partnership with Submission Processing Cashiers for accounts that are full paid to be identified and controlled on IDRS, then worked in ACS to determine the source of payment and issue the release. This process will become effective in FY 2006.

Return of Levy Proceeds

The report indicates that in some cases, IRS refuses to return funds levied between the date a collection agreement is agreed to and when the levy source receives the levy release. Additionally, the report asserts that ACS employees need additional training and guidance on levy releases and returning levied property. ACS employees explain the levy release process and its timing to taxpayers when they call requesting levy release. At that time, the assistor should address the timing issues between levy release issuance and IRS receipt of levy proceeds, and make those proceeds part of the collection agreement, if applicable. In those instances where the return of levy proceeds is appropriate, the IRM clearly outlines the procedures for our assistors. We feel the training material currently used for CPE adequately addresses the situations in which we should be releasing levies and returning funds. However, we will include a special emphasis on releasing levies promptly as well as the identification of situations in which consideration should be given to returning levy proceeds.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate is pleased that the IRS recognizes the importance that the levy release issue holds for taxpayers who have entered into installment agreements or for taxpayers who have demonstrated to the IRS that they are suffering economic hardships. We are also pleased that the IRS will study the feasibility of adding a systemic prompt for installment agreements in order to reduce the risk of levy release failure. In the case of installment agreements, we appreciate that the terms of the installment agreement will sometimes address the issue of levies in between the period when the installment agreement is approved and the levy is released. However, the IRS needs to consider that the Internal Revenue Code and governing Treasury Regulations require prompt levy release when an installment agreement is entered into. Thus, generally, the terms of installment agreements should not contemplate additional levies after the installment agreement is entered into.

With respect to timely levy releases, it is very encouraging that the IRS is implementing a new system enhancement that should reduce the levy release timeframe. With respect to expedited levy release procedures (i.e. where the ACS employees obtain a fax number for the levy source in order to fax the levy release), it is also important for ACS employees to consider the mind-set of taxpayers who have entered into an installment agreement or demonstrated an economic hardship. Most taxpayers do not understand IRS procedure nor do they always consider the processing time involved in levy releases. Thus, we again recommend that the IRS reverse the burden, which currently rests upon taxpayers to raise the issue of an expedited levy release. The IRS is in the best position to inform the taxpayer about expedited procedures and the implications of not sending a levy release by fax.

We are also very pleased that the IRS will include special emphasis on levy release procedure as part of its ACS training, and we offer the assistance of the Taxpayer Advocate

Service for offering the "taxpayer perspective" on these issues. Such emphasis is particularly important now that the IRS is levying against Social Security benefits under both the Federal Payment Levy Program and ACS Systemic Levies since these elderly and disabled taxpayers are likely to experience economic harm as a result of an IRS levy.[38]

[38] *See* Most Serious Problem: *Levies on Social Security Payments, supra.*

PROBLEM

TOPIC #12 MOST SERIOUS PROBLEM: REGULATION OF ELECTRONIC RETURN ORIGINATORS

RESPONSIBLE OFFICIALS

Bert Dumars, Director, Electronic Tax Administration

Kevin Brown, Commissioner, Small Business / Self-Employed Division

Richard J. Morgante, Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

The National Taxpayer Advocate has repeatedly raised the issue of the lack of IRS oversight of tax return preparers,[1] while the IRS has expressed its own concerns about the quality of preparer services and tax practitioners' standards of professional conduct.[2] The Treasury Inspector General for Tax Administration (TIGTA) has also voiced concerns about the IRS's authorizing individuals to participate in the *e-file* Program without ensuring they have met all required screening checks.[3]

Despite these persistent questions from inside and outside the IRS, there are still significant gaps in the IRS's regulatory regime for return preparers.

- The IRS's current *e-file* application process may not ensure that the IRS certifies only qualified individuals or groups to become part of the program.
- The IRS does not conduct adequate oversight of the activities of certified providers nor does it take sufficient steps to impose sanctions and penalties against those who violate the regulations.
- The IRS lacks a long-term strategic plan for the *e-file* Program and EROs that would unify the various IRS functions involved and ensure effective oversight of all EROs.

[1] National Taxpayer Advocate 2004 Annual Report to Congress 67-88, National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress, 216-230. *See also* House Committee on Ways and Means, Testimony of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service (Jul. 20, 2005).

[2] National Taxpayer Advocate 2004 Annual Report to Congress 82. *See also* House Committee on Ways and Means, Testimony of Nancy J. Jardini, Chief, Criminal Investigation Division, Internal Revenue Service (Jul. 20, 2005).

[3] Treasury Inspector General for Tax Administration, Ref. No. 203-30-039, *Improvements Are Needed in the Screening and Monitoring of E-File Providers to Protect Against Filing Fraud* (Jan. 2003).

ANALYSIS OF PROBLEM

Electronic Return Originators (EROs)

Background

A participant in the IRS *e-file* Program is an Authorized IRS e-file Provider.[4] Authorized *e-file* providers can be broken down into the following categories:[5]

- Electronic Return Originator (ERO),
- Intermediate Service Provider,[6]
- Software Developer,[7] and
- Transmitter.[8]

One of the most important categories of *e-file* provider is an ERO, which originates the electronic submission of income tax returns.[9] Once a taxpayer authorizes the filing of his or her return through the IRS *e-file* program, the ERO originates the actual submission by:

- Electronically sending the return to a Transmitter that will transmit the return to the IRS;
- Directly transmitting the return to the IRS; or
- Providing a return to an Intermediate Service Provider for processing prior to transmission to the IRS.[10]

The return submitted by the ERO must either be prepared by the ERO or collected from the taxpayer.[11] Although many EROs also engage in tax return preparation, that activity is separate and distinct from originating and electronically submitting the return

[4] An Authorized IRS *e-file* Provider (Provider) is a business authorized by the IRS to participate in IRS *e-file*. The business may be a sole proprietorship, partnership, corporation, or other entity.

[5] The Authorized IRS *e-file* Provider categories are not mutually excusive and a participant can fall under one or more of the different categories.

[6] Rev. Proc. 2000-31. An "Intermediate Service Provider" receives tax return information from an ERO (or from a taxpayer who files electronically using a personal computer, modem, and commercial tax preparation software), processes the tax return information, and either forwards the information to a Transmitter, or sends the information back to the ERO (or taxpayer).

[7] Rev. Proc. 2000-31. A "Software Developer" develops software for the purposes of formatting electronic tax return information according to Publication 1346, Electronic Return File Specifications and Record Layouts for Individual Income Tax Returns, or transmitting electronic tax return information directly to the Service.

[8] Rev. Proc. 2000-31. A "Transmitter" transmits electronic tax return information directly to the Service.

[9] Rev. Proc. 2000-31. The IRS *e-file* Program allows taxpayers to file their income tax returns through an Electronic Return Originator, or by using a personal computer, modem, and commercial tax preparation software (the Form 1040 IRS On-Line Filing Program).

[10] IRS Pub. 3112, *IRS e-file Application and Participation* (Nov. 2004).

[11] *Id.*

to the IRS.[12]

To become an ERO, an individual must apply to and be authorized by the IRS. Revenue Procedure 2005-60 informs authorized *e-file* providers of their obligations to the IRS, taxpayers and other participants in the program.[13] EROs must adhere to this revenue procedure and all publications and notices governing the *e-file* program. Failure to comply with the rules may lead to sanctioning by the IRS. Serious questions remain as to whether the ERO approval process is strict enough and whether the IRS is working to ensure that all taxpayers receive quality service by actively enforcing the requirements for EROs and imposing sanctions against those who fail to act appropriately.

Becoming an ERO

To become an ERO, a business must submit an application identifying its Principals and at least one Responsible Official.[14] The IRS conducts suitability checks on the applicant and all Principals and Responsible Officials listed.[15] The "suitability" process *may* include:

- A criminal background check;
- A credit history check;
- A tax compliance check to ensure that all required returns are filed and paid, and to identify fraud and preparer penalties; and
- A check for prior non-compliance with IRS *e-file* requirements.[16]

If any individual on the application fails the suitability check, the IRS will deny the application.[17] Only if all individuals pass will the IRS approve the application. The IRS provides approved applicants with an Electronic Filing Identification Number (EFIN) and credentials. The business is then free to begin operating as an Authorized

[12] An ERO that chooses to originate returns that it has not prepared, but only collected, becomes an income tax return preparer of the returns when, as a result of entering the data, it discovers errors that require substantive changes and then makes the changes. A nonsubstantive change is a correction limited to a transposition error, misplaced entry, spelling error, or arithmetic correction. All other changes are considered substantive and upon making a substantive change, the ERO is considered an income tax return preparer. As such, the ERO may be required to sign the tax return as the income tax return preparer. Treas. Reg. § 301.7701-15(d); IRS Pub.1345 *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns* (Nov. 2004).

[13] IRS, *Internal Revenue Bulletin* 2005-35 (Aug. 29, 2005).

[14] IRS Pub. 3112, *IRS e-File Application and Participation* (Nov. 2004). The roles are not mutually exclusive; a Principal may also serve as the Responsible Official. Each Principal or Responsible Official must be a U.S. citizen (or alien lawfully admitted for permanent resident), be 21 years of age as of the date of the application, and must meet applicable state and local licensing or bonding requirements for the preparation and collection of tax returns.

[15] *Id.* Applicants that only apply to be a Software Developer are not subject to a suitability check.

[16] *Id.*

[17] Applicants denied participation in IRS *e-file* will be notified in writing. The denied applicant may appeal the decision. If the IRS upholds the denial on appeal, the applicant may not reapply to become an Authorized IRS *e-file* Provider for the period specified in the denial letter. *Id.*

IRS *e-file* Provider and is subject to all of the rules governing the *e-file* program.

Although the elements of the IRS suitability check are significant, the IRS indicates only that it *may* include these items and does not guarantee that it *will* check on all elements before authorizing an ERO. The IRS conducts a full tax compliance check as well as a check for prior noncompliance in the *e-file* Program on approximately 95 percent of applicants.[18] However, the IRS does not conduct credit history checks. Further, it only requests Federal Bureau of Investigation (FBI) fingerprint checks for approximately 25 percent of applicants.[19]

Given the number of registered EROs, the IRS cannot perform in-depth suitability checks on *all* individuals listed on each application. However the current process may not be stringent enough to ensure that only qualified individuals become registered EROs. Table 1.12.1 shows that the number of registered EROs has grown each year since 2001.

TABLE 1.12.1, REGISTERED AND ACTIVE EROS SINCE 2001[20]

Year	Number of Registered EROs	Active EROs[21]
2001	No Data	74,876[22]
2002	121,671	87,526
2003	136,708	105,061
2004	197,164	142,477
2005	214,950	160,271

Applying to become a registered ERO is a one-time process with little follow-up on the individual's suitability once he or she is certified. Certified EROs must notify the IRS of any changes to their applications within 30 days. If a suitability issue occurs with a registered ERO, it generates a transcript on the IRS Master File, but this transcript does not account for all changes in an ERO's situation.[23] If an ERO commits a crime after being certified, this will not show up on the Master File. With no formal procedures for monitoring registered EROs, the IRS cannot be certain that only qualified individuals are registered.

[18] Those individuals who do not receive a full tax compliance check are not for profit organizations, large taxpayers, delegated users, and contacts or alternate contacts. Information provided by Operating Division in response to research request.

[19] Information provided by Operating Division in response to research request.

[20] *Id.*

[21] An active ERO is a registered ERO that filed at least one Form 1040 during the year.

[22] Wage and Investment Research, *Practitioner Counts by Number of Returns Filed, W&I Research Project 1-02-14-1-033.*

[23] IRS Master File is a system consisting of all tax data and related information pertaining to an individual or business taxpayer. The Master File is designed to reflect a continuously updated and current record of each taxpayer's account. The IRS has a system for both individuals – Individual Master File (IMF) – and businesses – Business Master File (BMF).

A significant discrepancy exists between the number of registered EROs and the number of active EROs. An individual accepted to the *e-file* Program must file at least one tax return within two years in order to remain in the program. The IRS initially ran a computerized program to identify EROs who failed to file returns within the two-year period, placed them in "Dropped" status, and notified them they were no longer part of the *e-file* Program.[24] However, since the IRS implemented the Third Party Data Store, it can no longer determine which EROs do not file returns.[25] The National Taxpayer Advocate is very concerned that the IRS is not tracking which EROs are not submitting returns and removing them from the *e-file* Program. The IRS should resume the tracking and require non-filing EROs to recertify.

Current Regulation of EROs

Once approved as an Authorized *e-file* Provider, an ERO's general responsibilities include:

- Timely originating of the electronic submission of returns;
- Submitting any required supporting paper documents to the IRS;
- Providing copies to taxpayers;
- Retaining records and making records available to the IRS;
- Accepting returns only from taxpayers and Authorized IRS *e-file* Providers; and
- Using only one EFIN for the same business entity at that location unless the IRS has issued more than one EFIN to a business entity at the same location.[26]

Beyond these general responsibilities, the IRS imposes other types of regulations on EROs depending on their activities. If an ERO chooses to assist a taxpayer in obtaining a Refund Anticipation Loan (RAL)[27] or other financial product, the ERO must undertake certain disclosures designed to ensure the taxpayer understands to what he or she is

[24] Information provided by Operating Division in response to research request.

[25] The Third Party Data Store is an IRS database used to create and update IRS *e-file* applicant information. IRM 3.42.10.3, *The Third Party Data Store* (Oct. 1, 2004).

[26] For this purpose, the business entity is generally the entity that reports on its return the income derived from electronic filing. The IRS may, for example, issue more than one EFIN to accommodate a high volume of returns. IRS Pub. 3112, *IRS e-File Application and Participation* (Nov. 2004).

[27] A Refund Anticipation Loan (RAL) is money a taxpayer borrows based on his or her anticipated income tax refund. For a detailed discussion of RALs, *see* Most Serious Problem: Refund Anticipation Loans: Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives, *supra.*

agreeing.[28] The ERO must explain to the taxpayer what a RAL is, as well as any fees or additional interest charged. The ERO can charge a flat fee for the RAL or other financial product, but cannot base its fee on a percentage of the taxpayer's anticipated refund or make the fee contingent on the amount of the RAL or other product.[29]

If an ERO advertises the availability of a RAL or other financial product, the advertisement must be easy to read and identify, and make clear that the taxpayer is borrowing money against his or her anticipated refund and is not receiving the actual refund.[30] The ERO must also ensure that the advertisements refer to RAL funds as a loan or other financial product, and not as a refund.[31]

Under Treasury Regulation § 301.7216, an ERO may disclose tax return information among Authorized IRS *e-file* Providers for the purpose of preparing a tax return.[32] However, if a taxpayer chooses to receive a RAL or other financial product, the ERO must obtain the taxpayer's written consent to disclose tax information to the financial institution providing the product.[33] Disclosing tax return information to receive a RAL or other financial product is not covered by the exemption in § 301.7216 for *e-file* providers. Failure to obtain written consent can result in penalties under IRC § 7216 or civil penalties under IRC § 6713 for unauthorized disclosure or use of tax return information.[34]

Current IRS Oversight

An authorized *e-file* Provider must comply with all other requirements or provisions contained in other publications and notices that govern IRS *e-file*. The Compliance function in the Small-Business Self-Employed (SB/SE) Operating Division is responsible for monitoring *e-file* Providers and sanctioning noncompliant ones.[35] This program includes monitoring visits to providers by the SB/SE Electronic Monitoring Coordinator (EMC), Tax Compliance Officers, and Revenue Agents.

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[28] The disclosures include ensuring taxpayers understand that by agreeing to a RAL or other financial product they will not receive their refund from the IRS as the IRS will send their refund to the financial institution; advising taxpayers that RALs are interest bearing loans and not a quicker way of receiving their refunds from the IRS; advising taxpayers that if a Direct Deposit is not received within the expected time frame for whatever reason, the taxpayers may be liable to the lender for additional interest and other fees, as applicable for the RAL or other financial product; advising taxpayers of all fees and other known deductions to be paid from their refund and the remaining amount the taxpayers will actually receive; and ensuring that if the ERO is also the return preparer, it is not a related taxpayer to the financial institution or other lender that makes a RAL or other financial product agreement within the meaning of § 267 or § 707A. IRS Pub. 3112, *IRS e-File Application and Participation* (Nov. 2004).

[29] IRS Pub.1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns* (Nov. 2004).

[30] *Id.*

[31] *Id.*

[32] The Treasury Regulations provide exceptions to the disclosure rules in IRC § 7216. For example, an ERO may pass on tax return information to an Intermediate Service Provider or a Transmitter for purposes of formatting and transmitting an electronic return to the IRS.

[33] IRS Pub.1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns* (Nov. 2004).

[34] *Id.*

[35] Information provided by Operating Division in response to research request.

The IRS may sanction a provider for the same reasons that it may deny an application. Before sanctioning, the IRS may issue a warning letter that describes specific corrective action the provider must take, though the IRS can also impose sanctions without a warning letter. An Authorized IRS *e-file* Provider that violates any of the requirements in Publication 1345 may receive a written reprimand, suspension, or expulsion from the *e-file* program.[36]

Depending on the seriousness of the infraction, the IRS may also publicize the name and owner of any entity suspended or expelled from participation in *e-file* and the sanction's effective date. The IRS may warn or sanction Authorized IRS *e-file* Providers that use the services of a denied, suspended, or expelled Provider, because such a business relationship is prohibited. However, if the IRS deems it appropriate, it may sanction the Provider without such warning.

The IRS categorizes sanctions – Level One, Level Two, or Level Three – according to the seriousness of the infraction.[37]

- Level One – The infraction has little or no adverse impact on the quality of the electronically filed returns or on IRS *e-file*. The IRS may issue a letter of reprimand for a Level One infraction.[38]
- Level Two - The infraction has an adverse impact on the quality of electronically filed returns or on IRS *e-file*.[39] Depending on the infraction, the IRS may either restrict a Provider's participation in *e-file* or suspend the provider from participating in *e-file* for the remainder of the current year and one additional year.[40]
- Level Three - The infraction has a significant adverse impact on the quality of electronically filed returns or on IRS *e-file*.[41] The IRS may suspend a Provider from participating in *e-file* for the remainder of the current year and one or two additional years for a Level Three infraction.[42]

If the infraction is severe enough, such as fraud or criminal conduct, the IRS may expel the Provider from the *e-file* program, denying it the opportunity to participate in the future.[43]

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36 IRS Pub. 3112, *IRS e-File Application and Participation* (Nov. 2004).

37 *Id.*

38 *Id.*

39 Level Two infractions include Level One violations that continue after the IRS has notified the Provider of the initial infraction.

40 IRS Pub. 3112, *IRS e-File Application and Participation* (Nov. 2004). If, as a the result of a sanction, a Principal or Responsible Official is suspended or expelled, every entity that listed the suspended or expelled Principal or Responsible Official on its IRS *e-file* Application may also be suspended or expelled.

41 Level Three infractions include Level Two violations, which continue after the IRS has notified the Provider of the initial infraction. *Id.*

42 *Id.*

43 *Id.* The IRS reserves the right to suspend or expel an Authorized IRS *e-file* Provider prior to administrative review for Level Three Infractions.

Once notified of a sanction, the Provider has the opportunity to appeal through an administrative review process.[44] Within 30 days of issuance of the notice of sanction, the Provider may mail a detailed explanation of why the IRS should withdraw the sanction.[45] The IRS will either withdraw the sanction or affirm it in writing, in which case the Provider may appeal to the Office of Appeals.[46]

Inadequate ERO Monitoring and Oversight Design

The current structure of IRS monitoring of EROs appears inadequate. The responsibility for certifying EROs is in the hands of Electronic Tax Administration (ETA) within Modernization & Information Technology Services (MITS). However, SB/SE is responsible for monitoring and sanctioning. This split oversight creates problems because no one in the IRS has complete responsibility for EROs. We believe end-to-end responsibility for EROs, from approval of applications to monitoring ERO activities, should rest within one IRS organization to ensure adequate and effective oversight.

The IRS cannot adequately assess the quality of ERO services and integrity of an ERO without conducting random and other site visits. Table 1.12.2 shows the number of EROs that receive an IRS visit each year.

TABLE 1.12.2, ERO VISITS[47]

Year	Number of IRS Visits	Percentage of Registered EROs Receiving Visit	Percentage of Active EROs Receiving Visit
2001	1,237	Data Unavailable	1.65%[48]
2002	1,412	1.16%	1.61%
2003	971	.71%	.92%
2004	1,294	.66%	.91%
2005[49]	1,104	.51%	.69%

A number of visits result from complaints about EROs from a variety of sources, including taxpayers, tax preparers, authorized *e-file* Providers, and IRS employees.[50] SB/SE

[44] IRS Pub. 3112, *IRS e-file Application and Participation* (Nov. 2004). In most circumstances, a sanction is effective thirty days after the date of the letter informing the Provider of the sanction, or the date the sanction is upheld by the reviewing offices or the Office of Appeals, whichever is later.

[45] During this administrative review process, an immediate sanction remains in effect.

[46] The appeal must be in writing and mailed to the IRS office that issues the recommended sanctioning letter within thirty calendar days of the date of the letter recommending the sanction. The Provider's written appeal must contain detailed reasons, with supporting documentation, to show why the recommended suspension or expulsion should not be imposed. Failure to respond within thirty calendar days of the date of any sanction letter irrevocably terminates the Provider's right to an administrative review or appeal.

[47] Information provided by Operating Division in response to research request.

[48] Wage and Investment Research, *Practitioner Counts by Number of Returns Filed, W&I Research Project 1-02-14-1-033.*

[49] As of September 24, 2005 (date of research request).

[50] Information provided by Operating Division in response to research request.

employees also conduct random visits, based on a sample selected from a central database of active EROs in a geographic area, to determine an ERO's general compliance with IRS requirements.[51]

SB/SE headquarters, in conjunction with ETA, annually decides the number of planned ERO visits. The number is usually one percent of all active *e-file* Providers in the local database; however, visits are limited to Providers that have electronically filed at least 25 individual tax returns.[52] Once SB/SE establishes the total number of visits, it schedules them in the following priority:

- Referral Visits – Referral visits are based on receipt of a complaint of alleged misconduct in the current year, or the issuance of a warning or written reprimand in the previous year.
- Follow-Up Visits – Follow-up visits are based on a previous year's referral where the visit resulted in an identified violation.
- Random Visits – Random visits are based on a non-discriminatory sampling of active *e-file* Providers selected from a central database.
- Targeted Visits – Targeted visits are based on specific selection criteria indicating *e-file* compliance issues may be present.[53]

Any referral or follow-up visits identified are mandatory. If the total number of mandatory visits exceeds the total number of planned visits, the area employees are still required to conduct all mandatory visits.

Although the IRS appears to have a well-developed plan for ERO visits, it actually does very little to enforce the ERO regulations. Even as the number of EROs has increased, the percentage of EROs visited has steadily fallen, as less than one percent of registered or active EROs received an IRS visit in the past three years. Many EROs may believe they do not need to meet the ERO requirements because there is little chance they will ever receive a visit from the IRS.

Further, IRS monitoring visits focus on infractions that affect the quality of the *e-file* Program instead of taking a broad-based look at whether a provider's activities affect the entire tax system. This form of oversight does not appear to take into account any actions by an *e-file* Provider outside of the *e-file* Program. According to IRS guidelines, the visits do not review whether an ERO is also a Circular 230 practitioner and has engaged in any Circular 230 violations. The narrow scope of these visits prevents the IRS from obtaining a complete and accurate picture of the activities of registered EROs.

Despite the low number of visits conducted each year, the number that result in enforce-

[51] Information provided by Operating Division in response to research request.

[52] *Id.*

[53] To select targeted visits, the area Electronic Monitoring Coordinator (EMC) must gather information needed to develop a list of potentially problematic *e-file* Providers.

ment action indicates the IRS needs to be more actively involved in monitoring EROs. Table 1.12.3 illustrates IRS actions against EROs for the past five years.

TABLE 1.12.3, IRS ERO SANCTIONS[54]

Year	Number of Visits	Number of Written Reprimands	Number of Warnings	Number of Proposed Suspensions	Number of Suspensions
2001	1,237	7	234	23	14
2002	1,412	117	No Data	38	60
2003	971	109	122	64	26
2004	1,294	154	224	244	31
2005	1,104	124	143	26	29

While suspension or expulsion from the IRS *e-file* program may be adequate remedies in some cases, they are not enough. In certain circumstances, the IRS can assess penalties against EROs who fail to meet regulations. The IRS may assess preparer penalties against any individual or group that meets the definition of an income tax preparer under IRC §7701(a)(36) and Treasury Regulation § 301.7701-15.[55] Under § 301.7701-15(d), persons, including EROs, are not considered tax return preparers within the definition of IRC § 7701(a)(36) – and therefore not subject to other preparer penalties – if their services are limited to:

- Typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund; or
- Making nonsubstantive changes, such as correcting a transposition, spelling, or arithmetic error (considered "mechanical assistance").[56]

If an ERO's actions in handling a tax return go beyond the definition of "mechanical assistance," it may be held liable for return preparer penalties.[57] However, though EROs may be subject to some preparer penalties, the IRS still cannot subject them to sizeable monetary penalties. The National Taxpayer Advocate has previously recommended a legislative change to impose a $1,000 penalty on EROs who repeatedly fail to comply with the *e-file* Program requirements.[58] The absence of a significant penalty for ERO abuses hampers the IRS' ability to provide effective oversight to EROs.

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54 Information provided by Operating Division in response to research request.

55 Preparer penalties that may be asserted under appropriate circumstances include but are not limited to those set forth in IRC §§ 6694, 6695, and 6713.

56 Treas. Reg. § 301.7701-15(d).

57 Treas. Reg. § 301.7701-15; Rev. Rul. 85-189, 1985-2 C.B. 341. EROs are defined as return preparers for purposes of IRC § 7216 and § 6713. Treas. Reg. § 301.7216-1(b)(2)(i) defines tax return preparer to include any person engaged in the business of preparing tax returns or providing auxiliary services in connection with the preparation of tax returns. The IRS also reserves the right to assert all appropriate preparer and nonpreparer penalties against an Authorized IRS *e-file* Provider as warranted. IRS Pub. 1345, *Handbook For Authorized IRS e-File Providers of Individual Income Tax Returns* (Rev. 11-04).

58 National Taxpayer Advocate 2003 Annual Report to Congress 273, 294-95.

In addition, penalties against EROs are useless unless the IRS assesses and collects them. The IRS is virtually a nonexistent presence in the preparer community, assessing only $8.5 million net in preparer penalties in the last five years and collecting less than 15 percent of the net assessed.[59]

TABLE 1.12.4, IRS ASSESSMENT AND COLLECTION OF ALL RETURN PREPARER PENALTIES FOR FY 2001-2005[60]

Fiscal Year	Total Amount of Return Preparer Penalties Assessed	Total Amount of Return Preparer Penalties Abated	Total Amount of Return Preparer Penalties Collected
2001[61]	$2,910,851	$186,400	$331,410
2002	$1,390,033	$80,493	$234,812
2003	$2,596,198	$10,000	$222,100
2004	$1,061,050	$44,500	$166,189
2005	$925,002	$1,000	$150,314
TOTALS	**$8,888,134**	**$322,393**	**$1,104,825**

IRS COMMENTS

IRS regulatory regime for return preparers.

The National Taxpayer Advocate addresses the e-file application suitability process and monitoring of Authorized IRS e-file Providers (Providers) as "significant gaps in the IRS' regulatory regime for return preparers." The IRS does not agree that return preparers should be regulated in the same manner as an ERO (Electronic Return Originators). Return preparers have responsibility for preparation of tax returns, which are not the same as the specific *e-file* responsibilities of EROs.

Firms apply and are accepted as Authorized IRS *e-file* Providers by the IRS upon meeting specific suitability checks. Return preparers, working for an ERO firm, are not required to obtain approval or complete a suitability process to prepare the tax return. The *e-file* application process for EROs, including the suitability process, does not include authorization for the preparation of tax returns.

Number of registered EROs versus the number of active EROs.

The National Taxpayer Advocate states that due to the implementation of the Third Party Data Store (TPDS), the IRS can no longer identify which EROs are not meeting the

59 Net penalties assessed are equal to the total amount of preparer penalties assessed, minus the total amount of penalties abated. Information provided by Operating Division in response to research request.

60 These statistics are for all preparer penalties – the IRS does not specifically track those preparer penalties imposed on preparers involved in the *e-file* Program. Information provided by Operating Division in response to research request.

61 While FY 2002-2005 data was extracted as of August 2005, the FY 2001 data was obtained from a prior September 2004 extract. Therefore, additional dollars collected or penalty abatements may have occurred in the intervening period.

requirement to file tax returns and therefore should no longer be part of the *e-file* program.

The IRS disagrees with the assertion that this is an important regulatory regime. There is no requirement that an ERO must file a tax return to remain an Authorized IRS *e-file* Provider. The IRS monitors the activities of EROs to determine if they are complying with requirements to continue to participate as an ERO.

Monitoring of EROs.

The Electronic Tax Administration (ETA) within Modernization & Information Technology Services (MITS) authorizes EROs while SB/SE is responsible for monitoring and sanctioning. The National Taxpayer Advocate recommends that the responsibility for approval of ERO applications and monitoring of ERO activities should reside within one IRS organization to ensure adequate and effective oversight.

The ETA was originally responsible for both certification and monitoring of the EROs. However, TIGTA issued a report dated September 13, 1999, reference #199940062, and recommended removing the responsibility for monitoring the activities of EROs from ETA. The IRS adopted this recommendation.

Assessing the quality of ERO services.

The National Taxpayer Advocate states that the IRS cannot assess the quality of ERO services, or the integrity of an ERO, without conducting random and other site visits. The IRS generally accomplishes monitoring through four types of visits scheduled in the following priority: Referrals, Follow-Up, Random, and Targeted. The total number of visits in 2005 were 1,100 of which 268 of the visits were Random (24%) and 385 were Targeted (35%) visits, which is more than half of the total visits.

Planning number of ERO visits.

SB/SE independently determines the number of planned visits using volume of ERO data provided to it by ETA.

Enforcement of ERO regulations.

The National Taxpayer Advocate acknowledges that the IRS has a well-developed plan for ERO visits, but needs to do more to enforce the ERO regulations. The National Taxpayer Advocate states that the number of EROs has increased while the percentage of EROs visited has decreased in the past three years.

The increase in EROs is primarily attributable to e-filers that prepare less than 25 returns per year. The IRS determines the appropriate mix of ERO visits within its available resources allocated to monitor EROs.

Focus of Monitoring

The National Taxpayer Advocate comments that the IRS monitoring visits should take a broad-based look at whether a provider's activity affects the entire tax system.

The IRS procedures call for employees to refer to the appropriate function other issues of noncompliance noted during monitoring visits not related to the e-file program. An exception to this general rule applies in cases where there are applicable penalties under IRC Section 6695(g) relating to Earned Income Tax Credit due diligence requirements. In addition, when warranted, monitors have sent referrals to the Area Return Preparer Coordinators (RPCs) for consideration of Program Action Cases (PACs).

TAXPAYER ADVOCATE SERVICE COMMENTS

Electronic Return Originators, along with return preparers, are the entry point for taxpayers into the tax system, and as such should be closely monitored in order to protect taxpayers. With the advent of *e-file*, many entities not traditionally involved with tax filing have entered the industry. These entities have unprecedented access to taxpayer financial data and social security numbers. While the IRS conducts suitability checks on all ERO applicants, the current checks are not enough to ensure that only qualified individuals become and continue as authorized EROs.

Despite the IRS's comments, the National Taxpayer Advocate remains concerned about the discrepancy between the number of registered EROs and the number of active EROs. Although the IRS states it monitors the activities of EROs to ensure they are complying with program requirements in order to remain a registered EROs, the IRS is unable to monitor every ERO. Moreover, since the IRS only visits EROs that prepare 25 or more returns, it does not visit inactive EROs and is not in fact monitoring them. These inactive EROs are still authorized to use and display the IRS's *e-file* logo. Yet the IRS sees no reason to investigate what these inactive but authorized EROs are doing with this IRS "imprimatur." One way to ensure that EROs are meeting program requirements is to require all EROs that have not filed a return in a certain amount of time (two years) to repeat the authorization process. This check on non-active EROs will monitor, in an economical manner, those EROs who received their authorization but never actively engaged in the e-file program, and are now looking to begin filing returns electronically.

The IRS moved responsibility for monitoring EROs from ETA to SB/SE following a September 1999 Treasury Inspector General for Tax Administration (TIGTA) audit, The Internal Revenue Service Can Improve Its Electronic Return Preparer Fraud Activities.[62] As discussed in the TIGTA report, the National Taxpayer Advocate recognizes that there is an inherent conflict of interest within the IRS – the Service is striving to meet its goal of 80 percent electronic filing, while also having to monitor and sanction those

[62] Treasury Inspector General for Tax Administration, Ref. No. 1999-40-062, *The Internal Revenue Service Can Improve Its Electronic Return Preparer Fraud Activities* (Sept. 1999).

individuals responsible for facilitating electronic filing.[63] This conflict still exists in the ETA's authorizing of EROs. If ETA were to promote e-filing, but another function oversees authorization and monitoring, the internal conflict is eliminated. In order to ensure adequate and effective oversight of EROs, end-to-end responsibility for EROs, from approval of applications to monitoring ERO activities, should rest within one IRS organization.

Although the IRS states that more than half of the visits to EROs each year are random and targeted visits, the National Taxpayer Advocate remains concerned that overall, the IRS is still not visiting enough EROs. The IRS conducted random visits on only 0.17 percent of the active ERO population in FY 2005, and only 0.24 percent of the active ERO population received targeted visits. This is hardly a meaningful presence in the ERO community. The IRS acknowledges that over the past three years, the number of EROs has increased, while the percentage of EROs visited has decreased. The IRS attributes this increase in EROs to e-filers that prepare less than 25 returns per year. Although these EROs may e-file a small number of returns, any improper action on their behalf affects the IRS and taxpayers the same as an ERO who e-files a large number of returns, and they should be treated the same as any other ERO. The National Taxpayer Advocate remains concerned that the number of IRS visits to EROs is not increasing in proportion to the number of registered EROs.

The National Taxpayer Advocate is pleased to learn that IRS employees refer any issues of noncompliance discovered during an ERO visit to the appropriate operating function. The National Taxpayer Advocate encourages the IRS to include on the ERO visit checklist items that would constitute grounds for a referral.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

- Reevaluate the current e-file application and certification process to ensure that the IRS certifies only qualified individuals or groups to become part of the program.
- Resume tracking which EROs are not filing any tax returns and require these non-active EROs to recertify.
- Consolidate end-to-end responsibility for EROs, from approval of applications to monitoring ERO activities, in one IRS organization to ensure adequate and effective oversight.
- Increase the number of IRS visits to EROs, including random visits, to ensure that registered EROs are operating within IRS guidelines.
- Strengthen the current sanction and penalty structure for violations of the *e-file* Program guidelines.

[63] Treasury Inspector General for Tax Administration, Ref. No. 1999-40-062, *The Internal Revenue Service Can Improve Its Electronic Return Preparer Fraud Activities* (Sept. 1999)..

- Ensure that current sanctions and penalties are imposed and collected consistently as a means to ensure compliance with program guidelines and deter future non-compliance.
- Develop a long-term strategic plan for the e-file Program and EROs that would unify the various IRS functions involved and ensure effective oversight of all EROs.

PROBLEM

TOPIC #13 MOST SERIOUS PROBLEM: LIMITED SCOPE OF BACKUP WITHHOLDING RULES

RESPONSIBLE OFFICIAL

Kevin M. Brown, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The latest estimate of the annual federal income tax gap[1] ranges from $312 billion to $353 billion.[2] Underreporting of individual income tax is the single largest source of the gap, accounting for over half of the gross tax gap.[3] Backup withholding is one of the tools available to the IRS as it attempts to narrow the tax gap.

Internal Revenue Code § 3406 provides the IRS with authority to require payors to deduct and withhold tax under certain conditions, such as when a recipient fails to furnish a valid Taxpayer Identification Number (TIN).[4] This system of "backup withholding" is designed to encourage compliance with tax laws.[5] However, the IRS has not implemented the backup withholding program effectively and has failed to provide noncompliant payors with sufficient incentive to fulfill their reporting obligations.

ANALYSIS OF THE PROBLEM

Background

Banks and other payors of certain kinds of payments (including interest, dividends, rents, royalties, and non-employee compensation) must file information returns with the IRS, even though these payments are generally not subject to withholding.[6] The IRS uses an automated matching program to determine whether the payee listed on the information return actually filed a return and reported the income. For the matching to succeed, the IRS must have a correct TIN for each payee who receives a reported payment. The payor may use Form W-9, *Request for Payee's Identification Number,* to obtain the payee's name, TIN, and entity type prior to making a reportable payment.[7]

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1 The tax gap is the difference between the tax that taxpayers should pay and what they actually pay on a timely basis. For a detailed analysis of the tax gap, *see* Most Serious Problem: The Cash Economy, *supra.*

2 IRS Office of Research, Analysis, and Statistics, *National Research Program: Early Results & Future Efforts* 2 (June 15, 2005).

3 *Id.* Individual income tax accounts for $198 billion to $234 billion of the tax gap, of which $150 billion to $187 billion is due to underreporting. Self-employment tax adds an additional $51 billion to $56 billion to the gross tax gap.

4 A TIN may be a Social Security number (SSN) issued by the Social Security Administration (SSA), an Employer Identification Number (EIN), or an Individual Taxpayer Identification Number (ITIN).

5 "The committee believes that if a taxpayer fails to supply his correct TIN to another person, withholding should be imposed to assure that taxpayers comply with the law." S. Rep. No. 97-494, 97th Cong. 2d. Sess. Vol. 1 (1982).

6 *See generally* IRC §§ 6041 – 6049.

7 Form W-9 shows not only the TIN, but also the entity type of the payee (*e.g.*, corporation, partnership, or sole proprietor).

The matching program fails when a payee gives the payor an invalid TIN (or no TIN at all). The absence of a valid TIN on an information return often makes it difficult and expensive for the IRS to match and verify the proper reporting of income on the tax return of the payee. The IRS considers a TIN missing if it is not provided or is obviously incorrect.[8]

If a payee fails to supply his or her TIN to the payor, or the Secretary notifies the payor that the TIN furnished by the payee is incorrect, the payor will impose withholding to assist the payee in complying with his or her tax obligation.[9] The payor will also implement backup withholding (at a rate of 28 percent for 2005[10]) if:

1. The IRS has notified the payor to start withholding on interest and dividends because the payee did not report all of his or her interest or dividend income in prior years;[11] or
2. The payee did not certify, when required, that he or she is not subject to backup withholding on interest and dividends.[12]

Payors who file information returns with missing or incorrect TINs are subject to a $50 penalty for each failure to include all of the required information.[13] The penalty rises to the greater of $100 or ten percent of the aggregate amount of the items required to be reported correctly if the payor intentionally disregards the reporting requirement.[14]

"B" and "C" Backup Withholding Programs

The IRS administers two separate backup withholding programs. The "B" program provides notices to *payors* who file information returns with *incorrect TINs*.[15] The IRS sends notices to advise payors that backup withholding could become necessary if payees fail to certify their TINs. The "B" program includes Forms 1099-B, -DIV, -INT, -MISC, -

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8 A TIN is also considered missing if it has more or less than nine numbers or it has an alpha character as one of the nine numbers.

9 IRC § 3406(a)(1)(A).

10 IRC § 3406(a) requires the payor to deduct and withhold from such payment a tax equal to the product of the fourth lowest rate of tax applicable under IRC § 1(c).

11 IRC § 3406(a)(1)(C).

12 IRC § 3406(a)(1)(D).

13 IRC § 6721(a) imposes a $50 penalty for each information return with respect to which such a failure occurs. The total amount imposed on such person for all such failures during any calendar year shall not exceed $250,000.

14 IRC § 6721(e).

15 Treas. Reg. § 31.3406(d)-5(d). Notice CP2100/CP2100A informs a payor that he or she may be responsible for backup withholding and includes a listing of the information returns that the payor filed that had missing, incorrect, or not currently issued TIN(s).

OID, and -PATR information returns.[16]

The "C" backup withholding program provides notices to *payees* who have *underreported* interest or dividend income or failed to file a tax return reporting such income when required.[17] These notices inform the payee what must be done to prevent backup withholding. The "C" program includes Forms 1099-DIV, -INT, -OID, and -PATR information returns.

This analysis will focus on backup withholding on non-employee compensation.[18] We limit our discussion to the "B" withholding program, as the "C" program pertains only to dividend and interest income.[19]

Processing of Information Returns

The IRS subjects information returns to numerous validity checks and eventually compares them to information on individual and business returns. Underreporter and nonfiler cases may result if these amounts do not match.

The IRS sends notices to payors who file information returns with incorrect TINs, advising them that backup withholding could become necessary if payees fail to certify their TINs.[20] Large volume filers receive a CP2100; filers of 50 or fewer information returns will receive a CP2100A.

The CP2100/CP2100A notice includes a list of the incorrect name/TIN combinations, which should be compared to the payor's list.[21] The payor is not required to notify the payee if the payee name/TIN combination on the notice is not the same combination

[16] Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions,* reports sales or redemptions of securities, future transaction, commodities, and barter exchange transactions of all amounts. Form 1099-DIV, *Dividends and Distributions,* reports distributions, such as dividends, capital gain distribution, or nontaxable distributions, that were paid on stock, and liquidation distributions of $10 or more ($600 or more for liquidations). Form 1099-INT, *Interest Income,* reports interest income of $10 or more. Form 1099-MISC, *Miscellaneous Income,* reports (1) rent or royalty payments; prizes and awards of $600 or more ($10 or more for royalties), (2) payments to crew members of fishing boats of all amounts, (3) payments to physicians and other suppliers of health and medical services of $600 or more, (4) payments for services performed for a trade or business by people not treated as its employees, or $600 or more, (5) fish purchases paid in cash or $600 or more, (6) substitute dividend and tax-exempt interest payments reportable by brokers or $10 or more, (7) crop insurance proceeds of $600 or more, and (8) gross proceeds or fees paid to attorneys of $600 or more. Form 1099-OID, *Original Issue Discount,* reports original issue discount of $10 or more. Form 1099-PATR, *Taxable Distributions Received from Cooperatives,* reports distributions from cooperatives to their patrons of $10 or more.

[17] Treas. Reg. § 31.3406(c)-1.

[18] Non-employee compensation includes payments made on Form 1099-MISC, *Miscellaneous Income,* for services performed for a trade or business by people not treated as its employees (*e.g.*, money paid to subcontractors).

[19] IRC § 3406(a)(1)(C).

[20] Treas. Reg. § 31.3406(d)-5(d).

[21] IRC § 6103(a) prohibits the IRS from disclosing tax return information, including the taxpayer's identity. Accordingly, the IRS can inform the payor that the information, which was provided by the payor on the information returns, is not correct, but cannot provide the correct name/TIN combination to the payor.

in the payor's records.[22]

If the payor's records contain the same name/TIN combination for the payee that the IRS has identified as incorrect, then the payor must determine if this is the first or second time within three calendar years it received notification of an invalid combination.[23] Payors are responsible for tracking the status of the notices they receive; the IRS does not designate whether a First or Second "B" notice is indicated.[24] A payor must take different actions for First and Second "B" notices:

First "B" Notice:

- A payor must send a First "B" notice and a copy of Form W-9, *Request For Taxpayer Identification Number and Certification*, to the payee within 15 business days of the date of the CP2100/CP2100A or the date the payor received it, whichever is later.
- A payor should include the return date, which should be no more than 30 business days after the payor received the CP2100/CP2100A, on the First "B" notice.
- A payor must begin backup withholding on payments to payees who do not respond to the First "B" notice by returning a signed W-9 by the return date specified on the "B" notice.
- The payor may begin backup withholding on payments to payees listed on the CP2100/CP2100A after notices are sent to the payee. A payor must stop backup withholding within 30 calendar days after receiving the W-9 from the payee.

Second "B" Notice:

If this is the second time within a three-year period that the same taxpayer[25] is listed on a CP2100/CP2100A notice, the payor must send the Second "B" notice to the payee. Unlike the First "B" notice, the Second "B" notice instructs the payee to contact the IRS or Social Security Administration (SSA) to obtain the correct name/TIN combination.

- A payor should send the Second "B" notice to the payee within 15 business days of the date of the CP2100/CP2100A notice or the date the payor received it, whichever is later.
- A payor should include the return date, which should be no more than 30 business days after the payor received the CP2100/CP2100A, on the Second "B" notice.

[22] It is possible that a payor's records disagree with the name/TIN combination identified by the IRS as incorrect due to a recent update to SSA records, an error in the information the payor submitted, or an IRS processing error. If this type of error occurred, the only thing the payor should do is correct or update its records if necessary. The requirement to send the payee the backup withholding "B" notice is only triggered if the payor's records contain the same incorrect name/TIN combination that is included in the list with the notice CP2100/CP2100A received by the payor.

[23] Two notices received during the same year count as one notice.

[24] A "B" notice is a backup withholding notice that warns the taxpayer that the TIN does not match IRS records and tells the taxpayer how to avoid backup withholding.

[25] With the same TIN and name combination.

- The payee must contact the SSA to validate a Social Security number[26] or the IRS to validate an EIN.[27]
- The payor may begin backup withholding on payments to the payee during the 30 business day period. If the payor does not receive the required validation[28] within 30 business days, the payor must begin backup withholding on payments to the payee if not already doing so.
- When the payor receives the required validation, the payor must stop backup withholding within 30 business days.

Payors with missing TIN accounts should not wait to receive a CP2100/CP2100A to begin backup withholding.[29] Backup withholding is required for a missing TIN at the time a reportable payment is made.[30]

Problems with Backup Withholding Program

The IRS received 346,101 Forms 1099-MISC for the 2003 tax year that did not include the payee's TIN. These documents reported payments of more than $2.5 billion.[31] The IRS received 314,934 Forms 1099-MISC with incorrect (not currently issued) TINS that reported payments of more than $2.7 billion for the 2003 tax year.[32] The IRS received more than 4 million Forms 1099-MISC for the 2003 year with name/TIN mismatches. These documents reported payments of between $31.7 billion to $53.7 billion.[33] The

[26] If the TIN is an SSN, the payee must request a Form SSA-7028, *Notice to Third Party of Social Security Number Assignment*, be provided to the payor. Form SSA-7028 is the form on which the SSA certifies that a SSN is assigned to a particular person. Also, the payee must give a copy of the Second "B" notice to SSA. The payor should use the corrected information on any future information returns (Forms 1099) he or she may file.

[27] If the TIN is an EIN, the payee must write to the service center where he or she files his or her tax return, ATTN: Entity Section, and ask for IRS Letter 147C. Letter 147C is a letter from the IRS that is used to validate an EIN/name combination. The payee must enclose a copy of the Second "B" notice with the request. The backup withholding regulations require that a payee request Letter 147C in writing. The payor should use the corrected information on any future information returns (Forms 1099) it may file.

[28] SSA Form 7028 or IRS Letter 147C.

[29] The CP2100 and CP2100A also list accounts with missing TINs, on which payors should have been back-up withholding.

[30] IRC § 3406(a)(1)(A).

[31] SB/SE response to Taxpayer Advocate Service Information Request (Oct. 24, 2005). Individual document report 406-10-14Aug. 6, 2004 and Feb. 15, 2005. Individual document report 406-10-14 provides stratified counts by ranges of income rather than an exact dollar amount. There were 346,101 documents with missing TINS that reported payments of between $2,456,552,446 and $3,995,007,600.

[32] Response provided by SB/SE to Taxpayer Advocate Service Information Request (Oct. 24, 2005). Individual document report 406-10-14 provides stratified counts by ranges of income rather than an exact dollar amount. There were 314,934 documents with incorrect or not currently issued TINs that reported payments between $2,710,980,346 and $4,397,566,900.

[33] Response provided by SB/SE to Taxpayer Advocate Service Information Request (Oct. 24, 2005). Individual document report 406-10-14 provides stratified counts by ranges of income rather than an exact dollar amount. There were 4,058,761 documents with name/TIN mismatches that reported payments between $31,676,332,553 and $53,700,505,700.

IRS issued 814,716 CP2100/CP2100A notices for the 2003 tax year.[34]

Limited Use of TIN Matching Program

In 2004, the IRS introduced an electronic TIN matching program allowing authorized payors[35] of income subject to backup withholding to match Form 1099 payee information against IRS records over the Internet before filing information returns. The TIN matching program will provide a "Match Indicator" for each name/TIN combination.[36]

Interactive TIN Matching will accept up to 25 payee TIN/name combinations on-screen, while Bulk TIN Matching can match up to 100,000 payee TIN/name combinations via a text file submission. The Bulk TIN Matching file is usually returned to the user within 24 hours.

The TIN matching program is strictly voluntary. IRS data shows that only 3,181 payors have used the program.[37] Because the program is expected to decrease backup withholding and penalty notices and reduce the error rate in TIN validation, the IRS should do more to promote TIN matching.[38]

Immediate Imposition of Backup Withholding

A major problem with the current backup withholding system is the delay in processing notices to payors. For backup withholding to effectively enhance compliance, the IRS should match withholding with income as it is earned. By the time a payor receives a backup withholding notice from the IRS, the payee (service provider) may no longer be receiving payments from the service recipient, meaning the IRS has lost the opportunity for backup withholding.

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34 Campus operations does not follow-up after the issuance of a CP2100/2100A notice. However, the LMSB and TE/GE functions both include a review of backup withholding activity within their individual industry reviews and audits. Response provided by SB/SE to Taxpayer Advocate Service Information Request (Sept. 22, 2005).

35 An authorized payor is one that has filed information returns with the IRS in at least one of the two past tax years.

36 The results or "Match Indicator" returned to the user is in a numerical format labeled as follows: "0" indicates the name/TIN combination matches IRS records; "1" indicates TIN is not a 9 digit number; "2" indicates TIN entered is not currently issued; "3" indicates the name/TIN combination does not match IRS records; "4" indicates an invalid TIN matching request; and "5" indicates a duplicate TIN matching request (the same name/TIN combination can only be submitted through the TIN matching program by the same payor one time).

37 SB/SE response to Taxpayer Advocate Service Information Request (Oct. 17, 2005). The number of payors using the program is cumulative from October 16, 2003, through date of response. During the period October 1, 2004, through June 30, 2005, 1.9 million TINs were submitted for verification in 700,000 interactive sessions. The program also successfully processed over 42 million name/TIN combinations through bulk processes between March 2004 and June 2005.

38 TIGTA recommended mandatory use of the matching program by payors, but this proposal may increase noncompliance by certain segments of taxpayer population (*e.g.*, it may cause undocumented workers to enter the cash economy and not file tax returns). See Treasury Inspector General for Tax Administration, Ref. No. 2001-30132, *Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors* 20 (Aug. 2001).

Payors must file Forms 1099 with the IRS by the end of February of the year following payment. Under current processing procedures, however, the IRS does not generate backup withholding notices until September or October of the year following payment (*i.e.*, October 2005 for payments made during 2004).[39]

In addition to improving the accuracy of information returns reporting non-employee compensation, the TIN matching program also represents a major opportunity to expedite the backup withholding notification process. For example, notification from the TIN matching program that a TIN/name combination is invalid could serve as notice to the payor to impose backup withholding.[40] This approach would eliminate significant delays and bring taxpayers into compliance sooner. At a minimum, when a TIN cannot be validated through the TIN matching program, this should serve the same purpose as a CP2100/CP2100A notice so that the payor is required to initiate contact with the payee to validate the information. If the correct information is not provided within a specified period, backup withholding should commence.

Lack of Reconciliation Process for Form 1099

The Combined Annual Wage Reporting (CAWR) program enables the IRS to ensure employers pay and withhold the proper amount of taxes and administer the advance Earned Income Tax Credit (AEITC) properly.[41] This program compares the Forms W-3/W-2/W-3c/W-2c[42] totals and the Forms 94X[43] employment tax returns. Under the CAWR program, the IRS matches five fields:

- Social Security wages;
- Social Security tips;
- Medicare wages;
- Federal tax withheld; and
- Advance earned income tax credit (AEITC).

Forms 1099 are conspicuously missing from the CAWR reconciliation process. In fact, there is no reconciliation of backup withholding information returns at all. The payor reports backup withholding in Box 4, Federal Income Tax Withheld, of Form 1099-

[39] IRM § 2.7.7.15(6). There are two mailings for each tax year, a staggered one in September and October and another in March the following year (*i.e.*, March 2006 for payments made during 2004).

[40] This approach would require a change to Treas. Reg. § 31.3406(j)-1(b), which states that matching details received by a payor through a matching program will not constitute a notice regarding an incorrect name/TIN combination under Treas. Reg. § 31.3406(d)-5 for purposes of imposing backup withholding.

[41] IRM § 4.19.4.1.

[42] Form W-2, *Wage and Tax Statement.* Form W-3, *Transmittal of Wage and Tax Statements*, contains totals for W-2s being transmitted. Form W-2c, *Corrected Tax Statement.* Form W-3c, *Transmittal of Corrected Wage and Tax Statements.*

[43] Forms 941, 943, 945, Schedule H (Forms 1040/1041).

MISC, but the IRS does not reconcile this data with any other information available.[44]

Without adequate follow-up, information return filers have little incentive to comply with their tax payment obligations. The IRS needs to develop a method of reconciling information returns with backup withholding.

Information Return Penalties Should Be Consistently Assessed

The IRS requires service recipients to file Forms 1099 with correct and complete information or face penalties of up to $50 per incorrect return. If the failure to file a correct information return is due to intentional disregard, the penalty increases to the greater of $100 or ten percent of the aggregate amount of the items required to be reported, with no limitation to the total amount of the penalties.

The IRS administrative criteria used to assess information return penalties exclude most of the payors who submit information returns with missing or invalid TINs.[45] To achieve any deterrence, the IRS needs to consistently assess penalties and make payors understand that there will be consequences if they do not take their responsibilities seriously.

IRS COMMENTS

The CP2100 and 2100A notices advise payors that there ***may*** be a discrepancy between the payee's name/taxpayer identification number (TIN) combination as listed on the payee's tax return and in the payor information documents provided to the IRS. The Small Business/Self-Employed Division (SB/SE) provides guidelines for issuing these notices in accordance with IRC § 3406.

The number of CP2100/2100A notices issued may not correlate to the number of payors imposing backup withholding for several reasons, such as errors in the payor records or that some recipients of Form 1099 are exempt from backup withholding. In the case of Form 1099-MISC, there can be a large difference between the CP2100/2100As issued and the imposed backup withholding when the 1099-MISC payees are classified as employees rather than independent contractors.

When backup withholding is required, payors must remit the backup withholding quarterly using Form 8109 and reflect the withheld amounts on the yearly Form 945 (Annual Return of Withheld Federal Income Tax). SB/SE reviews and reconciles the amounts withheld and imposes any payor penalties as a component of Employment Tax examinations. This process includes Forms 1099-MISC, which were the subject of the Advocate's review.

Specifically, examiners review transcripts to determine payor accounts that may be in violation of IRC § 3406. The examiners determine whether payors report wage data

[44] Filers of Form 1099 report backup withholding on line 2 of Form 945, *Annual Return of Withheld Federal Income Tax.*

[45] Treasury Inspector General for Tax Administration, Ref. No. 2001-30132, *Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors* 9 (Aug. 2001).

on Forms 1099-MISC for employees mistakenly classified as independent contractors. Furthermore, the examiners will verify that the IRS has notified the payors using CP 2100 and 2100A Notices.

Limited Use of TIN Matching Program

We believe that the TIN matching program is highly successful and widely promoted. The program successfully processed over 42 million name/TIN combinations through our bulk processes between March 2004 and June 2005. The program usage has demonstrated a remarkable level of proactiveness on the part of payors. They clearly are not waiting for the IRS to issue the backup withholding notices; rather, they are taking advantage of the TIN matching program at a time that suits their needs. Most of our participants have reported using the program throughout the tax year. Current reports show 4,188 payor entities (individual organizations or businesses) and 6,704 users participate in the program. On average, we have enrolled 2,094 payor entities during the two-year program operation period (October 2003 – October 2005).

The Treasury Department has proposed legislation twice to expand use of the program, most recently in the Good Government Act, although neither proposal was enacted. Further, IRS "markets" the program to employee groups, as well as external users, through the following efforts:

- Including TIN matching program announcements in quarterly communication plans, including providing informational packets to external payer groups and supplying materials to be posted on their web pages.
- Participating in payor group conferences throughout the year.
- Establishing an intranet site to post informational package materials, FAQ document, PowerPoint presentation, and publications for use by LMSB, SB/SE and TE/GE field industry agents.
- Establishing an email address for internal and external customers to communicate directly with a program analyst.
- Participating in tax forums and outreach efforts for the public.

Immediate Imposition of Backup Withholding

We agree that the system could be more effective if backup withholding were imposed immediately by payors who learn of a name/TIN mismatch. It would, however, create a "pay as you go" system for backup withholding similar to the requirements for 941s. This would be an additional filing requirement and burden for payors. The IRS also would face both internal and external systemic issues that could be cost prohibitive.

Lack of Reconciliation Process for Form 1099

We do not concur that a Form 1099 reconciliation process should be a part of the

Combined Annual Wage Reporting (CAWR) program. The IRS and the Social Security Administration (SSA) agreed to establish the CAWR program specifically to secure the missing Forms W-2 from employers that SSA could not obtain and to reconcile discrepancies between these documents and return filings.

Information Return Penalties

Internal Revenue Code § 6721(3)(d)(2) establishes exceptions for a *de minimis* number of failures to report correct or missing identification numbers. It states in part,

> "The number of returns to which the de minimis exception applies for any calendar year shall not exceed the greater of 10 or one-half of one percent of the total number of all information returns the filer is required to file during the year. If the number of returns on which the filer fails to include correct information exceeds the number of returns to which the *de minimis* exception applies, the *de minimis* exception applies to those returns that will afford the filer the greatest reduction in penalty."

This criterion automatically precludes imposing the penalty on a large population of Form 1099 payors with emphasis on the small business filer. Through application of the criteria, approximately 25 to 30 percent of the inaccurate filers are dropped from the penalty process. Still, SB/SE sent out approximately 50,000 proposed penalty notices to payors relating to missing and inaccurate identification numbers for FY 2005. Changing the criteria would bring many more filers into the penalty process.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the IRS for its efforts in establishing the electronic TIN matching program. She urges the IRS to continue exploring ways to increase usage by payors.

Tax compliance among non-wage workers has repeatedly been identified as a significant problem. For backup withholding to enhance compliance, the IRS should match withholding with income as it is earned. The IRS agrees that the system could be more effective if backup withholding were imposed immediately by payors who learn of a name/TIN mismatch, but expresses concern that this would create a "pay as you go" system for backup withholding, causing an additional filing requirement and burden for payors. We share this concern; this burden can be kept to a minimum by adding a validation requirement to the TIN program – that is, if in response to a mismatch, the payor requests verification from the payee and the payee is unresponsive, the payor must institute backup withholding. This approach drives resolution of TIN problems early in the hiring process and helps avoid TIN mismatches on annual documentation.

Currently, there is no automatic reconciliation of backup withholding information returns other than through employment tax examinations. The IRS does not agree with the National Taxpayer Advocate's recommendation that a Form 1099 reconciliation process should be a part of the Combined Annual Wage Reporting (CAWR) program. If there are better ways to reconcile backup withholding information, the National Taxpayer Advocate encourages the IRS to explore those alternatives.

RECOMMENDATIONS

The National Taxpayer Advocate's recommendations for improving administration of the backup withholding program are as follows:

- Explore the benefits and costs of making the TIN matching program mandatory for most payors and study the impact of excluding small payors (less than 10 employees);
- Require payors to impose backup withholding when a TIN cannot be validated;[46]
- Implement an automatic reconciliation process for backup withholding; and
- Consistently assess information return penalties under IRC § 6721.

[46] The payor should be required to contact payee to verify data. If correct data is not supplied within the same timeframe as under CP 2100 notice procedures, the payor should be required to commence backup withholding.

PROBLEM

TOPIC #14 MOST SERIOUS PROBLEM: ACCESSIBILITY OF E-SERVICES FOR TAX PRACTITIONERS

RESPONSIBLE OFFICIAL

Bert DuMars, Director, Electronic Tax Administration

DEFINITION OF PROBLEM

E-Services is a suite of web-based products available to tax practitioners who are active participants in the IRS *e-file* Program and electronically file five or more accepted individual income tax returns in a filing season.[1] The IRS Office of Electronic Tax Administration (ETA) uses the program "as a reward and incentive for e-filing."[2] The policy of limiting access to e-Services based on the number of e-filed returns deprives many highly trained and experienced tax practitioners, including practitioners associated with Low Income Taxpayer Clinics (LITCs), of this extremely useful and efficient tool.[3] At the same time, while denying access to highly skilled practitioners, the IRS allows others who may not even be authorized to practice before the IRS to use services that enable them to provide assistance beyond the mere preparation of tax returns.[4]

ANALYSIS OF PROBLEM

Background

E-Services allows registered tax professionals to do business with the IRS electronically 24 hours per day, seven days per week.[5] While e-Services is not available to the public,[6] all tax professionals currently have access to the following products:

- *Registration.* Through this program, tax professionals create electronic accounts to

[1] Factsheet, *e-Services Expands Incentive Products Access to More Tax Professionals starting February 28*, 2005. IRS Pub. 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns* and Rev. Proc. 2000-31, 2000-2 C.B. 146, specify the requirements for participating as an Authorized IRS *e-file* Provider and is the official set of rules that govern participation in IRS *e-file*.

[2] Kevin Belden, Chairman Electronic Tax Administration Advisory Committee, Reducing Taxpayer Burden – Expanding e-Filing and e-Services, Remarks Before the IRS Oversight Board (Jan. 29, 2002).

[3] The National Taxpayer Advocate is currently working to gain formal access to e-Services for the LITCs. The LITC program provides matching grants for qualifying organizations that represent low income taxpayers involved in controversies with the IRS and for organizations that provide tax education and outreach to taxpayers who speak English as a second language (ESL) or who have limited English proficiency (LEP). Qualifying clinics may not charge for their services or may charge only a nominal fee. IRC § 7526. In addition, they are prohibited from charging a fee for tax preparation.

[4] Statement of James D. Leimbach, Enrolled Agent, National Association of Enrolled Agents, Panama City, Florida, Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means (March 30, 2004); Statement of Claudia Hill, Government Relations Committee, National Association of Enrolled Agents, Gaithersburg, Maryland, Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means (April 08, 2003).

[5] IRM § 3.42.7.1.1.1 (Oct. 2004).

[6] IRS Pub. 3187, *IRS e-Strategy for Growth, Expanding e-Government for Taxpayers and Their Representatives* (Jan. 2005); IRM § 3.42.1.3.1 (Jan. 2005)

use e-Services products.[7] Over 86,000 tax professionals registered online between the launch of e-Services in summer 2004 and May 2, 2005.[8]

- *Preparer Tax Identification Number (PTIN) Application.* This application provides an option for each tax professional to choose a PTIN instead of his or her Social Security number (SSN).[9] The IRS received over 50,000 online PTIN requests from the program's launch through May 2, 2005.[10]
- *Online e-file Application.* This program provides a new online and paper e-file application process.[11]
- *Taxpayer Identification Number (TIN) Matching.* TIN Matching is a pre-filing service offered to payers listed in the IRS Payer Account File (PAF) database and their authorized agents, who submit information returns subject to backup withholding (Forms 1099-B, INT, DIV, OID, PATR, and MISC). Interactive TIN Matching provides payers the ability to match up to 25 payees' TIN and name combinations against IRS records. Bulk TIN Matching matches up to 100,000 TIN and name combinations.[12] Through May 2, 2005, e-Services processed over 39 million Bulk TIN Match requests and more than 1.5 million Interactive TIN Match requests.[13]

Tax professionals who e-file five or more accepted individual or business returns in one filing season are also eligible to use the following "incentive products:"[14]

- *Disclosure Authorization (DA)* – DA allows eligible tax professionals to complete authorization forms[15] as well as view and modify existing forms online. DA expedites processing and immediately acknowledges accepted submissions.[16] The program received over 16,000 Form 2848, *Power of Attorney and Declaration of*

[7] The registration process is a one-time automated process where the user selects a username, password and PIN. An on-screen acknowledgment confirms that the user has successfully completed the initial registration process.

[8] Wage & Investment Operating Division, *Filing Season Update*, 15-17 (May 2005). 36,532 registered in FY 2004 and 49,920 registered in FY 2005 through May 2nd. Note: Not all who register are eligible for services.

[9] The PTIN application enables a preparer to apply for and receive online a PTIN or look up a forgotten PTIN. An actual PTIN card can be sent if requested.

[10] Wage & Investment Operating Division, *Filing Season Update*, 15-17 (May 2005).

[11] The online e-Services program allows the application to be saved in progress and an acknowledgment of completion sent via email. Applications can be maintained and updated electronically and a new delegation of authority feature allows principals or responsible officials of the firm or organization to delegate e-Services to their employees.

[12] Interactive and Bulk TIN matching are not available if the firm has not filed information returns with the IRS in one of the past two tax years.

[13] Wage & Investment Operating Division, *Filing Season Update*, 15-17 (May 2005).

[14] ETA Fact sheet, *e-Services Expands Incentive Products Access to More Tax Professionals starting March 16, 2005.*

[15] Authorization forms include Form 2848, Power of Attorney and Declaration of Representative, and Form 8821, Tax Information Authorization.

[16] During the 2005 IRS Nationwide Tax Forums, tax professionals expressed frustration over the processing of Power of Attorney forms. This electronic platform may alleviate some of their concerns.

Representative, requests between its inception in the summer of 2004 and May 2, 2005.[17]

- *Electronic Account Resolution (EAR)* - Tax professionals with a Form 2848, *Power of Attorney and Declaration of Representative*, on file can electronically send and receive taxpayer account-related inquiries on such topics as individual or business accounts, refunds, installment agreements, missing payments and notices. The IRS delivers responses to a secure electronic mailbox within three business days. Through May 2, 2005, EAR received and processed over 4,700 requests.[18]
- *Transcript Delivery System (TDS)* - Practitioners with a Form 2848 on file can request and receive account transcripts, wage and income documents, tax return transcripts, and verification of non-filing letters for both individual and business taxpayers. Through May 2, 2005, TDS received over 69,000 requests for transcripts via the Registered User Portal.[19]

The IRS's 2004 E-File Practitioner Tracking Study found that approximately one-third to one-half of each of the four practitioner segments covered in the study[20] claimed awareness of e-Services, though only about one-fifth have used the services (with a high rate of satisfaction). In addition, approximately 75 percent of non-users in all the practitioner groups (except H&R Block employees) were interested in e-Services, especially the TIN and Electronic Account Resolution features.[21] The IRS found that practitioners serving mainly Spanish-speaking taxpayers had lower awareness of e-Services than the rest of the group, but their interest in it was stronger.[22]

Limited Access Policy

As the IRS developed e-Services in 2002, the Electronic Tax Administration Advisory Committee (ETAAC) strongly supported the IRS's plan to offer participating practi-

17 Wage & Investment Operating Division, *Filing Season Update*, 15-17 (May 2005).

18 *Id.*

19 *Id.* It is interesting to note that the usage increased significantly in 2005. There were 9,610 request in FY 2004 and 59,943 requests in FY 2005 through May 2nd.

20 The study broke the results down based on the following four groups: (1) 750 total practitioners excluding H&R Block and Jackson-Hewitt preparers (2) 400 practitioners serving mainly Spanish-speaking taxpayers excluding H&R Block and Jackson-Hewitt preparers, (3) 127 H&R Block preparers, and (4) 124 Jackson-Hewitt preparers. FCB & Russell, *Findings From the 2004 e-file Practitioner Tracking Study, PowerPoint Presentation to IMF Integration* 3 (July 2004).

21 Only 54 percent of H&R Block practitioners expressed that they were very or somewhat interested in using e-services. With 61 percent seasonal employees, the study found that H&R Block has a larger percentage of seasonal employees than the other groups. Jackson Hewitt had 41 percent seasonal employees and total practitioners excluding the two aforementioned tax preparation firms had 27 percent seasonal employees. FCB & Russell, *Findings From the 2004 e-file Practitioner Tracking Study*, PowerPoint Presented to July IMF Integration 2004, 6 & 19.

22 *Id* at 34.

tioners a "basket" of related electronic services as a reward and incentive for e-filing.[23] ETAAC believed the IRS should initially use e-Services to reward those practitioners who e-file at the highest rates by looking at the percentage rather than the number of returns e-filed. The committee believed this approach would open the program to low-volume filers who e-file a high percentage of their clients' returns. ETAAC also took the position that the IRS should eventually make the program available to all tax professionals.[24]

In response to the ETAAC recommendations, the IRS initially limited access to the e-Services incentive products (*i.e.*, Disclosure Authorization, Electronic Account Resolution, and Transcript Delivery System) to tax professionals whose firms e-filed 100 or more accepted Forms 1040 in the current or prior year.[25]

In ETAAC's 2004 Annual Report to Congress, the committee signaled recognition of an e-Services access problem. Although it had previously recommended that the IRS use e-Services as an incentive for high rate e-filers, ETAAC questioned whether the e-file threshold of 100 or more returns actually led substantial numbers of practitioners to e-file. ETAAC further stated that the restriction kept smaller practitioners from using e-Services and penalized tax professionals, most notably tax attorneys, who prepare few if any tax returns, much less e-file them, as a part of their tax practices. According to the committee, allowing all practitioners access to e-Services would demonstrate the benefits of operating in a digital world and in turn assist in the adoption of e-file.[26]

The IRS subsequently (in March 2005) lowered the e-file threshold from 100 or more accepted individual tax returns in a calendar year to five or more accepted individual or business returns. The IRS accelerated its expansion of the e-Services incentive products to a larger audience due to high demand and requests from tax professionals.[27]

ETAAC's most recent Annual Report to Congress applauded the IRS for lowering the threshold. However, the committee reiterated that the IRS is now positioned to open registration to all practitioners.[28]

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23 The Electronic Tax Administration Advisory Committee (ETAAC) is authorized under the Federal Advisory Committee Act, Pub. L. No. 92-463. ETAAC's provides continuous input into the development and implementation of the IRS's strategy for electronic tax administration. IRS ETAAC Factsheet.

24 Kevin Belden, Chairman Electronic Tax Administration Advisory Committee, *Reducing Taxpayer Burden – Expanding e-Filing and e-Services*, Remarks Before the IRS Oversight Board (Jan. 29, 2002).

25 IRS Pub. 3187, *IRS e-Strategy for Growth, Expanding e-Government for Taxpayers and their Representatives* (Jan. 2005); IRM § 3.42.1.3.1.

26 Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, Recommendation 4.4, (June 2004).

27 Electronic Tax Administration, Factsheet, *e-Services Expands Incentive Products Access to More Tax Professionals starting March 16, 2005*.

28 Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, 9 (June 2005).

E-File Incentive Questioned

The IRS has adapted an "IRS-centric" approach to e-Services rather than addressing it from a customer service-oriented perspective.[29] Electronic Tax Administration (ETA) data demonstrates that the current policy prevents over 665,000 tax practitioners from utilizing the program. This number represents approximately 60 percent of all practitioners included in the IRS preparer database.[30] It is important to note that this database does not track practitioners who do not prepare tax returns but operate solely by providing representational services to clients, such as controversy, transactional, and consulting services. Thus, the population of practitioners who are prevented from utilizing e-Services to better serve their clients, based on their low e-file rate, is likely to be far greater than 665,000.

Years before the launch of e-Services, the Treasury Inspector General for Tax Administration (TIGTA) urged caution in using electronic services as incentives for e-filing. In 2001, TIGTA stated that ETA's strategic plan could be interpreted as a decision to provide some electronic return originators (EROs) with an unfair advantage. This disparate treatment would inevitably affect taxpayers solely based on their selection of an ERO.[31]

Many tax practitioners who are ineligible for e-Services under the current policy could better serve their clients if they received access to these products The LITCs represent just one example of a group of practitioners that does not formally qualify to use e-Services but would greatly benefit from access. In fact, many knowledgeable tax practitioners who regularly represent clients before the IRS and have demonstrated a specific need for these services will never gain access under current policy simply because they do not e-file tax returns.[32]

Now that IRS Taxpayer Assistance Centers have drastically reduced their tax return transcript services, it is more important than ever to provide paid and volunteer tax

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[29] Kevin Belden, Chairman Electronic Tax Administration Advisory Committee, *Reducing Taxpayer Burden – Expanding e-Filing and e-Services*, Remarks Before the IRS Oversight Board (Jan. 29, 2002). The IRS currently uses the same tactic in the Volunteer Income Tax Assistance program (VITA) by providing more services to those VITA sites that e-file above a certain rate. IRM § 22.30.1.4.3.4(6).

[30] BMF 2005-010. The ETA Preparer database included 665,866 practitioners who filed between one and five tax returns during Processing Year 2003. This number represented 62 percent of the 1,073,995 total number of unique preparer IDs.

[31] Treasury Inspector for Tax Administration, Ref. No. 2001-40-049, *Management Advisory Report: Risks Should Be Weighed When Using Electronic Services as Incentives* 8-9 (Feb. 2001).

[32] In the communications plan for the e-Services revised threshold change, the IRS acknowledged data indicating sufficient capacity to expand accessibility to cover all EROs currently e-filing. Communication Plan, E-Services Threshold Change, 3 (Feb. 17, 2005).

practitioners access to the Transcript Delivery System feature of e-Services.[33] Further, practitioners at the 2005 IRS Tax Forums related how valuable TDS is when they receive new clients, as the system allows the practitioner to independently research tax histories rather than rely on clients to provide complete and accurate information. Just a few groups of practitioners who could benefit from TDS include:

- Bankruptcy lawyers filing petitions, who need TDS to ensure that all the tax-related debts of their clients are properly listed;
- Attorneys and Certified Public Accountants filing offers in compromise, who need copies of their clients' transcripts for all tax years at issue;
- Attorneys assisting clients with disaster claims, who need tax transcripts for complete and accurate information; and
- Attorneys handling decedent estates of taxpayers and preparing estate tax returns.

Electronic Account Resolution is another e-Services feature that would greatly benefit tax professionals who do not meet the current e-file threshold. The very nature of the EAR program warrants providing access to such practitioners because taxpayers who experience account issues may not go to their return preparer to resolve them, and may instead seek advice from a practitioner specializing in tax controversy services.

It is uncertain whether the IRS's policy of using e-Services as an incentive to e-filing has achieved its goal. While the e-file rate has clearly risen since the launch of the program in 2004,[34] it is unclear whether there is any clearly defined relationship between this increase and the growth in e-Services registration. In a 2004 IRS survey, 68 percent of practitioner V-Coders[35] indicated that they would switch to e-file if they had access to e-Services.[36] Subsequently, a 2005 IRS survey found that 29 percent of the previously surveyed V-coders had moved to e-file but did not give the reason for the change. In 2005, 47 percent of the former V-coders indicated that they were more likely to use e-Services. The IRS has acknowledged that this increased willingness to use e-Services does not prove that the product was the determining factor in the shift. Rather, the increase in interest may just reflect the increased usage of e-file. Nonetheless, the IRS has concluded that the survey clearly indicates that e-Services was at least a contributing

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[33] For a more in depth discussion of the IRS policy to restrict distribution of transcripts at TACs, *see* National Taxpayer Advocate 2004 Annual Report to Congress 8-25; *United States Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies*, 109th Cong. (April 7, 2005) (Statement of Nina E. Olson, National Taxpayer Advocate); *Joint Review of the Strategic Plans and Budget of the Internal Revenue Service: Hearing Convened by the Chairman of the Joint Committee on Taxation*, 109th Cong. (May 19, 2005) (Statement of Nina E. Olson, National Taxpayer Advocate).

[34] IRS News Release, *2005 Tax Filing Season Sets Records*, IR-2005-53, (April 28, 2005) ("The 66 million e-file returns accepted through April 22 topped the 62 million electronic returns received for all of 2004.").

[35] V-coders are practitioners who prepare tax returns on computer software but print out paper returns and file by mail.

[36] FCB & Russell Research, *Presentation of Findings, Practitioner Business Impact Study: Committed e-file Users vs. Committed V-Coders*, BMF Integration Meeting, screen 32 (September 2004).

factor due to the significant number of mentions it received in the survey.[37] The IRS appears to base the current policy on a conclusion for which there is no concrete data.

It has been brought to the attention of the Taxpayer Advocate Service that some practitioners who are ineligible for e-Services actually work out arrangements with other practitioners who can make use of the program. Under some of these arrangements, the names of e-Services eligible practitioners are added to the Form 2848, Power of Attorney and Declaration of Representative, merely to gain access to the program, in particular the Transcript Delivery and EAR features. These types of arrangements, although legal, are just one additional and unnecessary burden placed on practitioners and taxpayers by the IRS' policy of limiting access to e-Services.[38] They heighten both the disparity and inefficiency present in the policy.

Inappropriate Access

Basing access to e-Services on the rate of e-file has the unintended result of making the Electronic Account Resolution (EAR) program available to preparers without regard to their professional qualifications. Allowing access to any practitioner – no matter what training, experience, or knowledge of IRS representation he or she may possess – is not a logical policy. On the one hand, highly trained, experienced, and knowledgeable practitioners are denied e-Service products because they do not e-file enough returns; on the other hand, inexperienced or untrained practitioners are granted access to EAR.[39]

Although many Electronic Return Originators' activities are limited to tax return preparation, much of the information made available through e-Services does not apply to tax return preparation as a discrete function. In the case of untrained or inexperienced unenrolled preparers, access to such a program will not benefit taxpayers. Further, this practice may be counterproductive to effective and efficient tax administration.[40] For example, EROs could obtain account data that would enable them to prepare offers in compromise and financial statements, for a fee, without having to make their involve-

[37] FCB & Russell Research, *Findings from Practitioner Business Impact Research, PowerPoint Presentation*, screens 21-23 (July 2005) (The IRS stated, "with the ***quantitative*** evidence inconclusive on the issue of what tipped these former Committed V-Coders toward *e-file* we looked to their ***qualitative*** responses to a direct question about what made them change."); ETA Response to TAS Information Request (Sept. 19, 2005).

[38] TAS Attendance at Electronic Tax Administration Focus Group on E-Services, IRS National Tax Forum (Aug. 10, 2005)

[39] Statement of James D. Leimbach, Enrolled Agent, National Association of Enrolled Agents, Panama City, Florida, Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means (March 30, 2004).

[40] Circular 230 authorizes unenrolled preparers to practice before the IRS on a limited basis. Preparers can represent taxpayers before revenue agents, customer service representatives and similar IRS employees or officials on examinations of the tax period covered by the prepared return. Preparers are not authorized to represent taxpayers before Appeals, revenue officers, Counsel or other similar IRS employees or officials. 31 C.F.R. § 10.7(c)(1)(viii). Further, before the launch of the e-Services, practitioners in a focus group setting indicated that they had reservations about security and privacy with respect to the EAR. E-Services Focus Groups Results From the Nationwide Tax Forums 4 (2001).

ment known to the IRS.[41]

The National Taxpayer Advocate is concerned that the current accessibility policy of the e-Services program may enable unenrolled preparers to actually represent taxpayers behind the scenes using EAR. In effect, to increase electronic filing, the IRS may compound the problem of unauthorized practice.[42]

Conclusion

The current policy of limiting access to e-Services based on the practitioners' rate of electronic filing denies highly qualified tax professionals access to a product that could help them better serve their clients. [43] The program is extremely useful to practitioners and should not be merely a tool to entice preparers to e-file. It is not even completely clear whether the current policy has actually accomplished the goal of increasing the rate of practitioner e-file.

At the same time the IRS denies access to highly qualified tax professionals, e-Services may provide untrained and inexperienced tax professionals a way to practice before the IRS. Thus, the IRS needs to limit access to the EAR system to those tax practitioners who are qualified to practice before the IRS pursuant to Circular 230.[44]

IRS COMMENTS

We agree that the expansion of e-Services would benefit the IRS, the practitioner community, and taxpayers. As outlined below, we are pursuing options for adding additional groups to e-Services. One of our Information Technology Modernization Vision and Strategy long term goals is to expand the groups and numbers of customers that do business with the IRS through the web. The ultimate long range goal is to provide universal "E" to all taxpayers and tax professionals.

Currently, we have over 100,000 registered users of e-Services and over 200,000 participants in the IRS e-file program in our e-Services Third-Party-Database System. This is significant progress, since the e-Services incentive products, Electronic Account Resolution (EAR), Disclosure Authorization (DA), and Transcript Delivery System (TDS), have only been available for slightly over a year. We are pleased with these practitioners' acceptance and use of our e-Services products. However, expansion of these services must be balanced against the security risks associated with delivering tax return data over

41 Preparers of offers in compromise are not statutorily required to sign such submissions. For a more detailed discussion of this issue, see National Taxpayer Advocate 2003 Annual Report to Congress 270. *See* Most Serious Problem: *Regulation of Electronic Return Originators, supra*.

42 National Taxpayer Advocate 2004 Annual Report to Congress 67.

43 In conjunction with providing greater general access to the product, the IRS needs to ensure that it provides adequate training on the product's features as well as how to navigate through the product.

44 Statement of Claudia Hill, Government Relations Committee, National Association of Enrolled Agents, Gaithersburg, Maryland, Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means (April 08, 2003).

the Internet and the capacity of our data systems to service additional participants.

So far this year, the IRS has received over 68 million individual e-file returns and, for the first time, e-file receipts exceed paper. The IRS elected to make e-Services available to the vast majority of e-filing tax practitioners as an incentive because e-file generates significant cost savings to the government and reduces taxpayer errors. We attribute part of this year's e-file success to electronic return originators' acceptance of our e-Services suite of applications.

Consistent with our ability to address authentication issues and implement the necessary system changes, we agree that there are opportunities to expand access to the e-Services incentive products. The Low Income Taxpayer Clinics are one of the groups under active consideration. We also agree in principal that the others mentioned by the National Taxpayer Advocate should at some point have access to e-Services, particularly the TDS application.

Allowing access to "non-preparer" users is not as simple as lowering or eliminating the threshold of filing five returns. The current engineering and design of e-Services is tied to the *e-file* application process and the return threshold requirement. The *e-file* application process serves as an underpinning for sub-systems that drive the e-Services processes. This authentication process is crucial in order to know with whom we are doing business electronically to ensure that all IRC § 6103 provisions are followed when disclosing tax return information through the Internet. Adding access for those outside of the *e-file* application process will be a challenge requiring careful security planning, as well as additional programming and redesign.

We do not agree that e-Services changed any of the risk factors associated with "inappropriate access." The information available through e-Services is also available to practitioners and the public through our traditional telephone, correspondence, or walk-in channels. The only difference is in the method of delivery. Providing tax information to a properly authorized taxpayer representative is not inappropriate access, regardless of his or her level of training or enrollment, and denying such access would be inappropriate. In addition, the deployment of e-Services did not change any rules regarding practice before the IRS by electronic return originators or any other tax practitioners.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate is pleased that the IRS is pursuing options to expand access to e-Services to additional practitioner groups. We understand that the IRS faces a formidable task in balancing expansion of the program against the security risks associated with data transmittal over the Internet. Nonetheless, we encourage the IRS to make all efforts to expand access to the program as quickly as possible, while at the same time maintaining compliance with IRC § 6103 by carefully taking the necessary security measures to ensure that confidential tax data is highly safeguarded.

The IRS response indicates that expanding access would be a complex endeavor. It is our understanding that IRS data systems have the current capacity to handle expanded access to e-Services. Further, other than additional programming and redesign, the IRS has not provided any clear obstacles to prevent non-ERO practitioners from completing the authentication process, which is currently tied solely to the e-file application. By redesigning the system to apply the authentication process to non-ERO practitioners, the IRS would provide additional access to e-Services while ensuring that it safeguards data and complies with IRC § 6103.

Without supporting data, we cannot support the IRS policy of using e-Services access as an incentive to e-file. The Electronic Tax Administration Advisory Committee (ETAAC) has also taken the position that the IRS should stop using the program as an incentive. Although both e-file and e-Services have recently experienced impressive rates of growth, the IRS has not provided any tangible evidence to confirm its belief that access to e-Services is a main factor that causes a significant number of practitioners to increase their rate of e-file.

The National Taxpayer Advocate still has concerns that the e-Services suite is available to preparers without regard to their professional qualifications. The IRS claims that e-Services provide access to the same information already available through the telephone, correspondence, and face to face services. However, it makes no sense to provide easy access to tax account information to unenrolled preparers while at the same time precluding access for some highly qualified practitioners who are authorized to practice before the IRS under Circular 230. We encourage the IRS to confirm that e-Services does not provide a means for unenrolled preparers to practice beyond the parameters of "limited practice" as detailed in § 10.7(c) of Circular 230.

Finally, it has come to our attention through conversations with knowledgeable parties that some EROs are charging taxpayers fees of approximately $25 to receive expedited electronic transcripts. This is an example of how the IRS policy to limit access to such a useful program, the Transcript Delivery System (TDS) in particular, has had a detrimental and unintended effect on taxpayers. The IRS has created the opportunity for private industry to establish a commercial market for federal data that used to be and should be available free to all taxpayers.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS take the following actions:

- Expand access to e-Services to all practitioners qualified to practice before the IRS pursuant to Circular 230, while maintaining high security standards. This would entail redesigning the system to allow non-EROs to complete the authentication process.
- Confirm that access to e-Services, Electronic Account Resolution (EAR) in particular, does not create an opportunity for unenrolled preparers to practice before the IRS in a manner that goes beyond the limits of Circular 230.
- Develop e-Services access for all taxpayers to receive transcripts free of charge, while carefully taking the necessary security measures to ensure that confidential tax data is highly safeguarded as it is transmitted over the Internet.

PROBLEM TOPIC #15 — MOST SERIOUS PROBLEM: MANDATORY BRIEFINGS FOR IRS EMPLOYEES ABOUT THE TAXPAYER ADVOCATE SERVICE

RESPONSIBLE OFFICIAL

Beverly O. Babers, Chief Human Capital Officer

DEFINITION OF PROBLEM

Internal Revenue Code § 7803(c)(2)(C)(ii) requires the National Taxpayer Advocate and the Commissioner to develop guidance for all IRS officers and employees, outlining the criteria for referral of cases to the Taxpayer Advocate Service (TAS). Moreover, in her 2004 Annual Report to Congress, the National Taxpayer Advocate observed that two of the most serious problems facing taxpayers are access to TAS and a lack of adequate IRS training on taxpayer rights.[1]

To fulfill the statutory requirement and address the two problems referenced above, the National Taxpayer Advocate requested that the IRS include TAS training among its annual mandatory briefings for all IRS employees.[2] A required TAS briefing would make employees aware of the role and responsibilities of TAS, as well as when and how to refer a case to TAS. However, despite its assertion that training on taxpayer rights and TAS is "imperative," for employees,[3] the IRS refuses to make a TAS briefing mandatory for all employees.

ANALYSIS OF PROBLEM

Background

Taxpayer Access to TAS

Congress created the Office of the Taxpayer Advocate in part to help taxpayers solve their problems with the IRS.[4] To qualify for the Taxpayer Advocate Service's assistance, taxpayers must meet certain criteria based on the finding of "significant hardship" as outlined in IRC § 7811. Once a taxpayer meets the criteria, the taxpayer becomes eligible to receive free, independent, confidential, and personalized service from a knowledgeable Taxpayer Advocate. The advocate listens to taxpayers' situations, helps them understand what needs to be done to resolve their issues, and stays with them every step of the way until their problems are resolved to the fullest extent permitted by law.

Independent market research indicates that many taxpayers who could benefit from TAS services simply do not know about the organization. TAS reaches only about four

[1] National Taxpayer Advocate 2004 Annual Report to Congress 342-376.

[2] *Id.* at 373.

[3] *Id.* at 350.

[4] IRC § 7803(c)(2)(A)(i).

percent of the approximately 5.25 million taxpayers eligible for assistance.[5] More than 84 percent of those eligible taxpayers have never even heard of TAS.[6] The research group concluded that between 1.2 million and two million taxpayers with a TAS qualifying problem would be very likely to use TAS – if only they knew it existed.[7]

IRS Case Referrals

Aside from becoming aware of TAS through necessary public outreach initiatives, taxpayers could learn about TAS from referrals by IRS employees. Congress contemplated the importance of such referrals by directing the National Taxpayer Advocate and the Commissioner to develop guidance for IRS employees about TAS referral criteria. In her 2004 Annual Report to Congress, the National Taxpayer Advocate noted that without adequate training of IRS employees about the organization, TAS will remain the best-kept secret in the IRS – and, as a consequence, taxpayers will not receive the help they need to resolve problems.[8]

In fiscal year (FY) 2005, TAS has seen an increase of TAS cases identified as meeting TAS criteria by the IRS operating and functional division.[9]

TABLE 1.15.1, IRS REFERRALS TO TAS

Fiscal Year	TAS Receipts	Referrals from Operating and Functional Divisions	Percentage of total	TAS Other Case Receipts	Percentage of total
2004	168,856	69,916	41%	98,940	59%
2005	197,679	95,509	48%	102,170	52%

In the current IRS environment of increased compliance, we applaud the IRS operating and functional divisions for referring cases that meet TAS criteria. Helping customers to resolve their inquiries or complaints satisfactorily while protecting taxpayers' rights should be a primary goal of all employees. All IRS employees are encouraged to take responsibility for assisting taxpayers in resolving inquiries if this can be accomplished within the scope of their position. However, there may be occasions when normal procedures will not serve the taxpayer's best interest. In those instances, the IRS

5 Russell Market Research conducted a study for TAS, Findings From Task 149 – *The Taxpayer Advocate Service Research Program: With a Focus on the Detailed Study of the Underserved Segment – Phase II, Study # 3*, (July 2002), and estimated that between 3.9 million and 6.6 million taxpayers were eligible for TAS services. TAS used the midpoint range for its discussion in the 2004 Annual Report to Congress.

6 The Russell Marketing study stated: "As hypothesized in Phase 1 of the study lack of awareness of TAS is clearly part of the underutilization problem, with only three percent who met the TAS qualifying criteria for being Underserved aware of TAS voluntarily and with only 16 percent aware after prompting." Russell Marketing Research, *The Taxpayer Advocate Service Research Program: With a Focus on the Detailed Study of the Underserved Segment – Phase II, Study # 3*, (July 2002).

7 *See* National Taxpayer Advocate 2004 Annual Report to Congress 367.

8 *Id.* at 356-376.

9 TAS 2004 and 2005 case receipts were extracted from the Taxpayer Advocate Management Information System (TAMIS).

employee should evaluate the taxpayer's situation, determine if the case meets TAS Case Acceptance Criteria, and if so refer the case to the local TAS office.[10]

Statutory Requirement for TAS Training

IRC § 7803(c)(2)(C)(ii) requires the National Taxpayer Advocate to develop guidance for distribution to all IRS officers and employees outlining the criteria for referral of taxpayer inquiries to local Taxpayer Advocate Service offices. In October 2001, the Treasury Inspector General for Tax Administration (TIGTA) conducted a review to determine if the National Taxpayer Advocate had implemented the provisions of IRC § 7803(c).[11] TIGTA found that TAS had developed the required guidance about TAS case eligibility criteria and educated IRS employees about those criteria. However, TIGTA also found that TAS could not ensure that the IRS provided the criteria awareness training to all intended employees. TAS had published its case criteria on its internal IRS website and worked to update Internal Revenue Manual (IRM) references to these criteria. Local TAS instructors also presented criteria awareness training to IRS employees during continuing professional education (CPE) seminars, workshops, and group discussions. The reach of this training was limited, however, because TAS does not have authority to require IRS functions to participate, and had no process in place to track those employees who received TAS training.[12]

TAS Briefing Development

In response to the TIGTA audit, TAS developed *TAS Annual Guidance for IRS Officers and Employees* (Document 11189 Certification Process). Initially, in an effort to correct the deficiencies TIGTA identified, Local Taxpayer Advocates and other TAS employees attended many IRS CPE programs annually to provide specific training on TAS case acceptance criteria and manually record attendance.[13] In FY 2004, TAS conducted 945 of these briefings.[14]

In FY 2005, TAS converted its training materials to a web-based (IRS intranet) briefing that teaches employees about TAS criteria and how to properly refer qualifying cases, while also identifying TAS' mission, roles, structure, and responsibilities. It takes 20

[10] The IRM contains numerous cites directing IRS employees to refer cases to TAS. *See, e.g.*, IRM § 3.12.3.3.15 – *Form 911 Hardship* (Submission Processing), 4.2.1.14 – *Taxpayer Advocate Program* (Examinations); IRM 5.19.9.3.7.1- *Taxpayer Advocate Service Cases* (Collections); 21.1.3.18 – *Taxpayer Advocate Service* (TAS) *Guidelines* (Customer Account Services).

[11] Treasury Inspector General for Tax Administration, Ref. No. 2002-10-002, *The National Taxpayer Advocate Needs to Ensure Operations Employees Training to Identify Cases* (Oct. 2001).

[12] *Id.*

[13] Service Level Agreement Between the National Taxpayer Advocate and The Commissioner, Wage and Investment Division; Service Level Agreement Between the National Taxpayer Advocate and the Commissioner, Small Business / Self-Employed Division.

[14] National Taxpayer Advocate 2004 Annual Report to Congress 370.

minutes for an IRS employee to complete the briefing,[15] which tracks participants and completion.

IRS Position on TAS Mandatory Briefing

The IRS currently requires all employees to complete several mandatory briefings.[16] In FY 2005, they included:

- Ethics Awareness;[17]
- Prevention of Sexual Harassment (POSH);[18]
- Computer Security Awareness;[19]
- Unauthorized Access Awareness (UNAX);[20]
- Safety and Health;[21] and
- No FEAR Act.[22]

Although these briefings use valuable IRS employee time and resources, the IRS makes the training mandatory because of the considerable importance of the topics covered and because these briefings are required by statute, or by administrative directives or policy statements.

In FY 2004, the National Taxpayer Advocate requested the IRS to include the TAS web-based training as one of the IRS mandatory employee briefings. This request was an effort to meet the statutory requirement to deliver guidance to all IRS employees – and a recognition that taxpayers are best served by IRS employees who are mindful of taxpayer rights.[23] The IRS rejected this request. TAS then requested that the IRS include

[15] There is also an Annual TAS Guidance for IRS Public Contact Managers. On average, it should take approximately 45 minutes to complete the briefing. See *Annual TAS Guidance for IRS Public Contact Managers*.

[16] In a memo titled New Hire Policy from Human Capital Office to IRS Heads of Office: The IRS New Hire Policy clarifies the requirements for new hires on taking the annual Mandatory Briefings. New hires or seasonal employees who are returning to duty and complete the briefings on or after January 1, do not need to retake the briefings during the May – September cycle, except when a briefing has been significantly revised.

[17] Ethics Awareness as prescribed by Article 52, Section 5 of the IRS/NTEU National Agreement.

[18] IRS Policy Against Sexual Harassment, Document 7591 (Rev. 5-2001); Memorandum from Mark W. Everson, Commissioner of Internal Revenue to all IRS employees on Prevention of Sexual Harassment Policy Statement, (June 2, 2004).

[19] Computer Security Awareness as required by the Computer Security Act of 1987, Pub. L. No. 100-235, 100 Stat. 1724 § 5; IRM § 25.10.1.

[20] Unauthorized Access Awareness as required by the Taxpayer Browsing Protection Act 1997, Pub. L. 105-35.

[21] Safety and Health as mandated by the Department of Treasury, Treasury Directive 71-05, *Departmental Safety and Health Programs* (Aug. 19, 2002).

[22] No FEAR Act as required by the Notification and Federal Employee Anti-Discrimination and Retribution Act, Pub. L. No. 107-174, 116 Stat. 566.

[23] National Taxpayer Advocate 2004 Annual Report to Congress 373-374. TAS plans to supplement this web-based training with face-to-face training in certain functions on specific issues directly related to the function's workload.

TAS training for all employees in the FY 2006 mandatory briefings, and then only for public contact employees in FY 2007. The IRS also rejected this follow-up request. The IRS did agree, however, to deliver the TAS training to Wage & Investment (W&I) and Small Business/Self-Employed (SB/SE) division contact employees and managers (excluding IRS Accounts Management employees) in FY 2005. The IRS also suggested that TAS send an e-mail or a memorandum to the remainder of the workforce to provide guidance or instructions on where to find the TAS training.[24]

To reach the applicable "contact" employees, the TAS Learning and Education staff worked with representatives from the operating divisions to ensure the successful coordination and delivery of TAS training. During FY 2005, over 27,000 IRS employees completed the TAS training.[25] Despite the usefulness and economy of the mandatory training approach, for FY 2006 the IRS has made a preliminary determination not to include TAS training as a mandatory briefing.

Current IRS Training is Not Adequate

In FY 2005, the TAS Office of Systemic Advocacy formed a task force to review certain compliance-related IRS training course materials for taxpayer rights protection content, including whether the materials adequately addressed the role and authority of TAS.[26] The task force found that, with one exception, the role and possible involvement of TAS was rarely discussed in the evaluated courses and that there was little coverage on non-enforcement case resolution alternatives in the courses dealing with collection enforcement techniques.[27] Based on these findings, it appears that IRS employees are not receiving the information they need to know when and how to refer taxpayers to TAS.

The IRS's FY 2005 plans to deliver TAS training to certain public contact employees and managers were a step in the right direction. However, the limited training was a disservice to taxpayers and did not comply with the spirit – if not the letter – of IRC § 7803(c)(2)(C)(ii). All IRS employees interact with taxpayers on a constant basis, both professionally and personally. To a large extent, ***all*** IRS employees are public contact employees. When a person realizes that he or she is speaking to an IRS employee,

[24] Human Capital Office Response to TAS Information Request (Oct. 14, 2005); Office of the Commissioner Response to TAS Information Request (April 11, 2005).

[25] In FY 2005, 11,178 Wage and Investment (W&I) Division and 15,828 Small Business and Self-Employed (SB/SE) Division managers and employees have completed the briefings. W&I Response to TAS Information Request (Oct. 6, 2005); SB/SE Response to TAS Information Request (Oct.13, 2005).

[26] Taxpayer Rights Training Team, *Taxpayer Rights Training FY 2005 Report* (Sept. 30, 2005), on file with the Taxpayer Advocate Service. The Taxpayer Rights Training Team reviewed compliance related training for Revenue Officers, Revenue Agents, Tax Compliance Officers, Tax Examiners and Automated Collection System (ACS) employees in the IRS Small Business/Self-Employed Division.

[27] *Id* at 4. The Report noted that there was one "standout exception" to the general finding that the evaluated courses did not adequately address TAS issues. Course 17402, *Revenue Officer CPE, Part 1: Enforcement & Investigative Tools, Part 2: Seizures* (Rev. May 2005) contained discussions of taxpayer rights related to seizure actions and covered the requirement to advise affected taxpayers about TAS and provide and explain IRS Form 911, *Application for Taxpayer Assistance Order*.

tax and IRS related questions generally ensue. Taxpayers ask questions regardless of the IRS employee's title or job description. Invariably, many of these questions relate to the inquiring taxpayer's own experiences and problems with the IRS. TAS may be able to help solve some of these problems, but only if taxpayers know TAS is available.

It is not unreasonable to conclude that many taxpayers would receive TAS help if they learned about TAS through formal or informal conversations with an IRS employee. Unfortunately, because only select IRS employees receive TAS training, TAS awareness is unnecessarily limited. When a taxpayer speaks to an untrained IRS employee about specific problems, the employee may not know how to contact TAS, may not know whether TAS can help the taxpayer, or may not even know that TAS exists. Mandatory training for all IRS employees will help ensure that employees have the information necessary to refer a taxpayer to TAS when the opportunity arises.

Mandatory Briefings are an Efficient Training Method

Although an ideal approach would be to provide face-to-face TAS criteria training to all IRS officers and employees, a better use of the IRS's limited resources would be to provide basic, issue-recognition training by computer. TAS could supplement the computer training by directing face-to-face training resources to public contact areas of high importance. This targeted approach would deliver interactive training with case studies specific to each particular IRS program (examination, collections, etc).

The IRS has recommended that TAS work out arrangements with the operating divisions to include TAS training in their continuing professional education (CPE) programs as an alternative to the IRS mandatory briefing.[28] However, service-wide face-to-face presentations are very labor intensive and require a large human resources commitment. The IRS also suggested that TAS provide an email or memo to employees instructing them where to find additional guidance. However, this approach does not guarantee that a significant percentage of employees will actually take the training, nor does it provide a method to track which employees complete the training. Including the training as part of the web-based IRS mandatory briefing is an efficient mode of delivery to all IRS officers and employees and provides a method of tracking participation.

Mandatory web-based training is also a cost benefit to the IRS in a more indirect way. If IRS employees are adequately informed about TAS criteria, they will refer cases to TAS early on in the process where appropriate, rather than allowing the cases to languish unnecessarily in various parts of the IRS.

IRS employees also respond well to web-based training and briefings. After the second year of online mandatory employee briefings, the IRS Human Capital Office (HCO) reported that, on a scale of 1 to 5 (with 5 being very satisfied and 1 being very dissatisfied), IRS employees gave online mandatory briefings a rating of 4.3 or higher for

[28] Office of the Commissioner Response to TAS Information Request (April 11, 2005); National Taxpayer Advocate 2004 Annual Report to Congress 372.

content, usability, and understanding.[29] HCO stated that these high ratings indicated that employees had a "very positive experience" with online briefings and "the understanding of the key messages of the briefings increased significantly for all."[30]

CONCLUSION

Generally, training and developing employees has many benefits, including increased job satisfaction, productivity, and employee motivation. In the IRS's current environment of increased compliance, referring a case to TAS when it meets TAS criteria is not only good for taxpayers – it is simply good customer service. Customer service plays an important role in enforcement activities and often makes the difference in resolving an issue. Good customer service is not just the responsibility of the IRS public contact employees or managers, it is the responsibility of every IRS employee.

Pursuant to the Congressional directive in IRC § 7803(c)(2)(C)(ii), the IRS must fully commit to train all of its employees about the role of TAS and TAS criteria. An efficient manner to provide this training to all IRS officers and employees would be to include a TAS briefing in the IRS mandatory briefings. These annual briefings are a good introduction to TAS Case Acceptance Criteria, and can be supplemented with program-specific training about the availability and importance of TAS assistance through interactive case studies.[31]

IRS COMMENTS

The IRS agrees with the National Taxpayer Advocate that our employees are encouraged to take responsibility for assisting taxpayers in resolving inquiries if this can be accomplished within the scope of their position.

The IRS workforce is comprised of "contact" and "non-contact" employees. The two largest IRS divisions, Wage and Investment (W&I) and Small Business/Self-Employed (SB/SE) have a significant workforce of "contact" employees. The W&I Division serves 116 million individual taxpayers with wage and investment income only. The SB/SE Division serves approximately 45 million taxpayers that are fully or partially self-employed individuals and small businesses. The contact employees in these Divisions are the primary points of contact for most taxpayers and constitute the employee base that resolves inquiries within the scope of their positions.

Because all IRS employees do not have public contact, the IRS does not agree with the Advocate that all IRS employees interact with taxpayers on a constant basis, both professionally and personally. Therefore, the IRS does not agree that all employees need to

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29 IRS Human Capital Office, Leadership and Education, *Report on the Successful FY 03 Online Delivery of Mandatory Employee Briefings* (Oct. 28, 2003).

30 *Id.*

31 National Taxpayer Advocate 2004 Annual Report to Congress 342-355, 370-371. Taxpayer Rights Training Team, *Taxpayer Rights Training FY 2005 Report* (Sept. 30, 2005).

be trained on TAS roles and responsibilities and when/how to refer a case to TAS. The TAS training delivered to contact employees in W&I and SB/SE, specifies the criteria for referring taxpayers to TAS, which includes making determinations on whether a taxpayer meets economic or systemic hardship. The TAS training would not be relevant to the roles performed by our other contact and non-contact employees.

Consequently, the IRS does not want ***all*** employees trained to evaluate the taxpayer's situation, determine if the case meets TAS Case Acceptance Criteria, and refer the case to the local TAS office. Making these determinations is outside the scope of our other contact and non-contact positions, and will likely result in inappropriate referrals to TAS, which is a disservice to taxpayers. The IRS encourages TAS to promote all-employee awareness of their organization by using established internal communication products and services.

In its final audit report, *The National Taxpayer Advocate Needs to Ensure Operations Employees Receive Training to Identify Cases* (Audit 200110023), the Treasury Inspector General's Office "found that the Taxpayer Advocate Service (TAS) developed guidance outlining the criteria for identifying cases to be referred to the TAS. The TAS provided guidance through internal manuals, the IRS Intranet, and criteria awareness training." Where TAS needed to take corrective action was to "ensure it has provided the training on identifying cases to the intended IRS employees." Our new training administration system (Enterprise Learning Management System) tracked completion of all students and managers, allowing TAS to ensure that training on identifying cases was provided to the intended employees.

The law requires the National Taxpayer Advocate to develop guidance to be distributed to all Internal Revenue Service (IRS) officers and employees outlining the criteria for referral of taxpayer inquiries to local offices of the taxpayer advocate. The law does not require the IRS to commit to train all of its employees on the role of TAS and TAS criteria. The IRS is training all appropriate contact employees about TAS but recommends that TAS initiate other actions to promote program awareness to all IRS employees, such as, posting information on the IRS's intranet page, inserting a pamphlet in Leave & Earning statements, and developing and distributing wallet cards.

TAXPAYER ADVOCATE SERVICE COMMENTS

Internal Revenue Code § 7803(c)(2)(C)(ii) requires the National Taxpayer Advocate and the Commissioner to develop guidance and distribute it to ***all*** IRS officers and employees outlining the criteria for referring taxpayer inquires local taxpayer advocate offices. The National Taxpayer Advocate recognizes that the statute does not specifically require the IRS to "commit to train all of its employees on the role of TAS and TAS criteria," but she does not believe her statutory obligation can be adequately fulfilled without some means of ensuring that each IRS employee is made aware of the Taxpayer Advocate Service's role and when it is appropriate to refer a case to a local TAS office. The IRS response indicates that it is content to read the statute so narrowly as to construe "distribute" to mean exactly that – and nothing more.

The IRS suggests that the National Taxpayer Advocate fulfill her statutory obligation by posting information on the IRS intranet page, inserting pamphlets in employee Leave & Earning statements, and distributing "wallet cards." To be sure, each of these suggestions would "distribute" TAS information to IRS employees, but they are no replacement for interactive training. The IRS intranet page typically contains more than 50 links to numerous topics ranging from IRS research tools, to employee directories, to local weather forecasts. There is no assurance that a significant number of IRS employees would even find a TAS criteria link on the IRS intranet, let alone voluntarily click on the link and read the material provided. Distributing pamphlets in Leave & Earning statements or "wallet cards" to employees would in fact be a literal distribution (and we already plan to conduct such efforts), but there would be no means of tracking employee receipt or use of such cards. Moreover, these "passive" outreach initiatives are best used as a supplement to interactive learning.

The National Taxpayer Advocate believes that the most effective and efficient way to fulfill her statutory obligation to make ***all*** IRS employees aware of TAS and TAS criteria is through mandatory web-based computer training. Including the training as part of the web-based IRS mandatory briefings is an efficient mode of delivery to all IRS officers and employees and provides an effective method of tracking participation. This training should be supplemented by face-to-face sessions with public contact employees in appropriate national and local settings, as well as distribution of such "passive" memory aids as wallet cards.

The National Taxpayer Advocate recognizes the IRS cooperation in providing web-based mandatory briefings to many contact employees. She notes, however, that the statute makes no distinction between "contact" and "non-contact" employees. The National Taxpayer Advocate appreciates that some IRS employees have more public contact than others and that some employees may have very limited public contact while performing their official duties. However, to say that some IRS employees have no public contact either professionally or personally simply ignores reality. All IRS employees can expect to be asked questions about the IRS. The National Taxpayer Advocate believes that

Congress contemplated this very reality when specifying that TAS guidance be given to *all* IRS employees. An employee adequately informed about TAS and TAS criteria will know how to contact a local TAS office and when it is appropriate to refer a taxpayer question to TAS.

Mandatory web-based training would improve taxpayer service and provide a cost benefit to the IRS. If all IRS employees are adequately informed about TAS criteria, they will refer cases to TAS early on in the process where appropriate, rather than allowing the cases to languish unnecessarily in various parts of the IRS.

RECOMMENDATION

The National Taxpayer Advocate recommends that the IRS assist the Taxpayer Advocate Service and the Commissioner in complying with the requirements of IRC § 7803(c)(2)(C)(ii) by including TAS training among its annual mandatory briefings for all IRS employees. The TAS developed training will cover the role of the National Taxpayer Advocate and the Taxpayer Advocate Service in assisting taxpayers and improving tax administration as well as the criteria for referral of taxpayer inquiries to local offices of the taxpayer advocate.

PROBLEM

TOPIC #16 **MOST SERIOUS PROBLEM: ALLOWABLE EXPENSE STANDARDS FOR COLLECTION DECISIONS**

IRS RESPONSIBLE OFFICIAL

Kevin M. Brown, Commissioner, Small Business/Self Employed Operating Division

DEFINITION OF PROBLEM

The IRS is required to publish schedules of national and local expense allowances to be used as guidelines for making offer in compromise (OIC) decisions.[1] The IRS also uses these guidelines to determine how much a taxpayer should pay under an installment agreement and whether to pursue collection or place a taxpayer's account in "currently not collectible" (CNC) status.[2]

The guidelines (called "standards") are an important tool that the IRS must use carefully to resolve collection matters appropriately. If the IRS uses unrealistic expense allowance standards or applies them rigidly, it will resolve fewer collection matters through installment agreements or offers, force taxpayers to endure economic hardships (or force them into bankruptcy), and reject offers and installment agreements that represent its best opportunity for collection. If the IRS allows too few expenses, taxpayers who obtain installment agreements or offers will be more likely to default on them because the payment terms will not be realistic. Conversely, if the IRS allows too many expenses, it may forego revenue that it could collect. Despite their importance, the standards have a number of important limitations:

- *Standards omit significant expenses.* If the IRS, taxpayers, or practitioners rely solely on the standards, they may overlook significant costs such as healthcare and childcare because no standards exist for these expenses.
- *Standards not realistic for some.* Even if the IRS has an allowance standard for a given expense, the standards are unrealistic for some individuals because they are based on aggregate expense statistics for large groups of people in wide geographic areas.
- *Standards not used to ensure that taxpayers can provide for basic living expenses.* The IRS does not use the standards as a floor to prevent its collection activities from depriving a taxpayer of basic living expenses. For example, if a taxpayer does not have a basic living expense because he or she cannot currently afford the item, then the IRS does not automatically take the expense into account, even if it is for some-

[1] An OIC is an offer to compromise a tax liability based upon doubt as to liability (DATL), doubt as to collectibility (DATC), or in furtherance of "effective tax administration" (ETA). *See* Form 656, *Offer in Compromise* (Rev. 7-2004); Treas. Reg. § 301.7122-1, *et. seq.* The IRS typically compares a taxpayer's income to allowable expenses to determine how much of the taxpayer's income could reasonably be paid to the IRS while still allowing the taxpayer to provide for basic living expenses. *Id.*

[2] *See* IRM § 5.16.1.1 (Jan. 1, 2004). In addition, pursuant to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, bankruptcy courts use the same guidelines to evaluate whether a taxpayer's net income is so high as to raise a presumption that a Chapter 7 bankruptcy filing is abusive. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L No. 109-8, § 102 (enacted April 20, 2005).

thing as important as housing or health care.[3]

- *Perception that IRS uses the standards to avoid responsibility for rejecting reasonable collection alternatives.* Many practitioners feel that the standards are sometimes unreasonable and that the IRS often applies them rigidly, using them as an excuse to reject reasonable collection alternatives.[4]
- *The IRS does not track how often employees fail to allow necessary expenses that exceed or are not included in the standards.* The IRS cannot reliably assess practitioner concerns that IRS employees use the standards as an excuse to reject reasonable collection alternatives because the IRS does not track how often taxpayers request deviation from the standards or how often the IRS employees improperly deny such requests.

ANALYSIS OF PROBLEM

Background

Legislation enacted in 1998 requires the IRS to prescribe guidelines to determine whether to accept an offer in compromise.[5] The legislation states that:

> [t]he Secretary shall develop and publish schedules of national and local allowances designed to provide that taxpayers entering into a compromise have an adequate means to provide for basic living expenses…. The guidelines shall provide that officers and employees of the Internal Revenue Service shall determine, on the basis of the facts and circumstances of each taxpayer, whether the use of the schedules … is appropriate and shall not use the schedules to the extent such use would result in the taxpayer not having adequate means to provide for basic living expenses.[6]

[3] *See, e.g.*, IRM § 5.8.5.2.2(3) (Nov. 15, 2004). The IRS might allow a necessary future expense if the taxpayer could document how much it would cost. *See* IRM § 5.15.1.1(6) (May 1, 2004). However, it may be difficult for taxpayers to document future expenses in a way that will satisfy the IRS.

[4] *See, e.g.*, Statement of Robert McKenzie on behalf of the American Bar Association Section of Taxation, *Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means*, April 8, 2003, *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=274; American Association of Attorney-Certified Public Accountants, *Position on Allowable Expenses*, July 31, 2002, *available at* http://www.attorney-cpa.com/i4a/pages/index.cfm?pageid=3321; T.D. 9007, 67 Fed. Reg. 48,025, 48,028 (Jul. 23, 2002); SB/SE Research, 2003 *Nationwide Tax Forum Focus Groups Customer Satisfaction Issues of Practitioners*, Project 01.08.005.03, 8 (2003).

[5] IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3462(a) (1998) (codified at IRC § 7122(c)). The IRS had previously adopted, in September of 1995, national and local standards for determining allowable expenses, which were designed to ensure uniform treatment of similarly situated taxpayers. *See* T.D. 8829, 64 Fed. Reg. 39,020, 39,022 (Jul. 21, 1999).

[6] IRC § 7122(c)(2).

The IRS refers to the guidelines as national and local expense allowance standards. The expense allowance standards fall into three categories:

- National standards. The IRS established national standards for food, housekeeping supplies, apparel and services, personal care, and miscellaneous expenses.[7] They vary by family size and income. Separate schedules, with slightly higher allowances, apply to taxpayers in Hawaii and Alaska.[8]
- Local standards. The IRS established local standards for housing and utilities.[9] They vary by county (and some cities) and family size.
- Transportation standards. The IRS standards for transportation expenses have both local and national components, but the IRS considers them to be local standards. A single vehicle ownership expense allowance applies nationwide, but vehicle operating expenses (and public transportation expenses) vary by census region and metropolitan statistical area (MSA).[10]

The IRS updates the standards each year using what it determines to be the best data for various stratified regions and market segments.[11] The IRS uses the standards to guide its determination of a taxpayer's basic living expenses.[12] The following table summarizes how the IRS calculates each component of the standards.

7 IRM § 5.19.1.4.3.1(1) (Dec. 15, 2002); IRS, *National Standards for Allowable Living Expenses, available at* http://www.irs.gov/businesses/small/article/0,,id=104627,00.html.

8 A single vehicle ownership expense amount is applied nationally, with no separate schedule for Alaska or Hawaii. *See* IRS, *Allowable Living Expenses for Transportation, Collection Financial Standards, Financial Analysis - Local Standards: Transportation, available at* http://www.irs.gov/businesses/small/article/0,,id=104623,00.html.

9 IRM § 5.19.1.4.3.2(2) (Dec. 15, 2002); IRS, *Housing and Utilities Allowable Living Expenses, available at* http://www.irs.gov/businesses/small/article/0,,id=104696,00.html.

10 *See, e.g.*, IRM § 5.19.1.4.3.4 (Dec. 15, 2002); IRS, *Allowable Living Expenses for Transportation, Collection Financial Standards, Financial Analysis - Local Standards: Transportation, available at* http://www.irs.gov/businesses/small/article/0,,id=104623,00.html. The U.S. is divided into four multi-state census regions. *Id.* MSAs are multi-county or city areas that are assigned different standards than the census region in which they are located. *Id.*

11 *See* SB/SE Research - Brooklyn/Hartford, *2005 Allowable Living Expenses*, Project No. 01.08.002.04, 1 (Dec. 2004).

12 *See, e.g.*, Treas. Reg. § 301.7122-1(c)(2)(i) (providing that "[A] determination of doubt as to collectibility will include a determination of ability to pay. In determining ability to pay, the Secretary will permit taxpayers to retain sufficient funds to pay basic living expenses. The determination of the amount of such basic living expenses will be founded upon an evaluation of the individual facts and circumstances presented by the taxpayer's case. To guide this determination, guidelines published by the Secretary on national and local living expense standards will be taken into account.").

TABLE 1.16.1, ALLOWABLE EXPENSE STANDARD CALCULATIONS[13]

	Expense Standard	Data Source	Measurement	Geographic Area	Update Frequency and Inflation Adjustment
National	◆ Food ◆ Housekeeping Supplies ◆ Apparel and Services ◆ Personal Care Products and Services	Bureau of Labor Statistics (BLS) Consumer Expenditure Survey (CEX)[14]	Average expense by gross income level (using eight income ranges) and family size (up to a family of four).	National, but with separate tables for Alaska and Hawaii.	CEX expense data are published annually to report prior year survey results. The IRS adjusts the data for inflation, including inflation projected through June 30th of the year in which the standard will be used.[15]
	◆ Miscellaneous	N/A	A discretionary amount of $100 plus $25 (as of 2004) for each additional family member.[16]	National, but with separate tables for Alaska and Hawaii.	Beginning in 2004 the IRS began annually adjusting the base amount for inflation.
Local	◆ Vehicle Ownership Cost	Federal Reserve Board of Governors	The average monthly payments on new (first car) and used car (second car) loans for the five most recent years.[17]	National.	Federal reserve data are published annually. The IRS does not adjust this data for inflation.
	◆ Vehicle Operating and Public Transportation Costs	CEX	The average public transportation and vehicle operating expenditures based on two years of data. The IRS projects the marginal costs of each car for a maximum of two cars.	By each Metropolitan Statistical Area (MSAs), and Census Region.	The IRS uses annual CEX data and adjusts it for inflation, including inflation projected through June 30th of the year in which the standard will be used.[18]
	◆ Housing and Utilities	Census 2000 Detailed Table H91, and CEX	The IRS adds *average* home maintenance, telephone service and garbage collection expenses from CEX data to the *median* mortgage payment from Census data to obtain the standard for a family of three. The result is reduced by 15% for families of two or less and increased by 15% for families of four or more.	By each county in the fifty states, Puerto Rico and the District of Columbia.[19]	The government publishes updated Census data every 10 years and CEX data annually. The IRS adjusts it for inflation, including inflation projected through June 30th of the year in which the standard will be used.

13 *See* SB/SE Research - Brooklyn/Hartford, *2005 Allowable Living Expenses*, Project No. 01.08.002.04, 3-6, 9, Appendix C (Dec. 2004).

14 The CEX is described in more detail at http://www.bls.gov/cex/csxfaqs.htm.

15 CEX expense data is adjusted to reflect both past and expected future inflation for the first six months of the year in which the standard will be used. For example, because 2001 CEX data was the most recent data available to the IRS when it calculated the expense standards that it would use in 2004, the IRS adjusted the data for inflation using the CPI-U by applying: (1) The 2002 CPI-U to adjust for inflation through December 2002, (2) the 2003 half-year CPI-U to adjust the data for inflation through June 2003, and (3) a forecasted CPI-U to adjust the data for inflation for the July 2003 through June 2004 period.

16 IRM § 5.15.1.7 (May 1, 2004). However, the expense tables reflect that for families with more than four members, the miscellaneous expense allowance increases by between $134 and $209 for each additional member, depending on family income. *See* IRS, *National Standards for Allowable Living Expenses, available at* http://www.irs.gov/businesses/small/article/0,,id=104627,00.html (Jan. 1, 2005).

17 The IRS allows an additional $200 per month to cover auto repairs if the taxpayer has no loan or lease payments and the vehicle has either more than 75,000 miles or is more than six years old. IRM § 5.8.5.5.2(3) (Sept. 1, 2005).

18 The IRS uses the CPI applicable to the specific MSA or Census Region to adjust local standards for inflation. For locations within one of the MSAs, the IRS uses the CPI applicable to the MSA. For those areas not within an MSA, the IRS uses the CPI applicable to the appropriate Census Region.

19 In some areas, such as in Alaska, the IRS uses geographic regions that do not correspond to counties.

The Internal Revenue Code requires the IRS to deviate from the standards based upon the taxpayer's facts and circumstances.[20] However, the Internal Revenue Manual (IRM) provides that for local standard expenses, the IRS should allow taxpayers the standard amount or the amount actually paid, whichever is less, so that the standard serves as a "cap" on allowable expenses.[21] Perhaps because the IRS uses the local standards as a cap, it requires taxpayers to provide documentation to support all expenses subject to them.[22] In contrast, the IRS will allow taxpayers to claim expenses included in the national standards without documentation, unless they exceed the standard.[23]

Standards Omit Significant Expenses

The IRS has no expense standards for a number of significant necessary expenses. For example, health insurance, healthcare, and childcare are significant necessary expenses for which no standards exist.[24] For families paying for childcare in 1997, one estimate found the average expense to be $3,432 per year, the second largest in a family's budget after housing.[25] For those with medical expenses in 2002, one estimate found the aver-

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20 IRC § 7122(c)(2).

21 IRM § 5.19.1.4.3.2(2) (Dec. 15, 2002) (stating: "Unlike the national standards, the local standards for housing, utilities, and transportation serve as a cap. The taxpayer is allowed the local standards or the amount actually paid, **whichever is less**." (Emphasis in original.)); IRM § 5.15.1.7(4) (May 1, 2004) (same). *See also*, IRS, *Collection Financial Standards, at* http://www.irs.gov/individuals/article/0,,id=96543,00.html (last visited Sept. 2005). Such a cap appears contrary to the Code and legislative history. *See* IRC § 7122(c)(2); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288 (1998) (stating "if the facts indicate that the use of scheduled allowances would be inadequate under the circumstance, the taxpayer is not limited by the national or local allowances.").

22 IRM § 5.19.1.4.3.2 (Dec. 15, 2002). However, the IRS will sometimes allow a small amount of health care expenses and vehicle operating expenses without documentation. IRM § 5.8.5.2.2(4) (Nov. 15, 2004); IRM § 5.8.5.5.2 (Sept. 1, 2005).

23 IRM § 5.15.1.3(5) (May 1, 2004).

24 IRM § 5.15.1.10 (May 5, 2004). Other examples may include the cost of caring for non-dependents, *e.g.*, where children stay with non-custodial parents during the summer or on weekends, where children support their retired parents, or where parents support their adult children with no other means of support. IRS guidance could be clearer in describing the extent to which such costs may be allowed. *See, e.g.*, IRM § 5.15.1.7(8) (May 1, 2004) and IRM § 5.15.1.10 (May 1, 2004).

25 *See* Linda Giannarelli and James Barsimantov, *Child Care Expenses of America's Families, Occasional Paper Number 40*, 4 (Dec. 2000) *available at* http://www.urban.org/UploadedPDF/310028_occa40.pdf. A survey of childcare expenses conducted in 1999 found that for children under age 14 they averaged $79 per week or $4,108 per year, and rose to $94 per week or $4,888 per year for children under age five. U.S. Census Bureau, *Who's Minding the Kids? Child Care Arrangements: Spring 1999 Detailed Tables (PPL-168)* (Jan. 2003) *available at* http://www.census.gov/population/www/socdemo/child/ppl-168.html (PPL Table 6). For additional background information, *see* Staff of Comm. on Ways and Means, *2004 Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means*, Section 9, 9-15, 9-16 (Comm. Print 2004) *available at* http://waysandmeans.house.gov/Documents.asp?section=813.

age to be $3,302 per year.[26]

The absence of expense standards for such large necessary expenses means that the IRS will not properly take them into account unless taxpayers remember to retain their receipts (or get quotes for future expenses) and include such expenses on their financial statements, and IRS employees use good judgment in allowing them.[27]

> **Example:** A newspaper delivery person with pancreatitis and injuries resulting from an automobile accident needed prescription medications and routine healthcare. She had no health insurance, and could not afford the care that her doctors recommended. In evaluating her financial condition, the IRS Compliance function did not allow healthcare expenses (or health insurance expenses) of $200 per month ($2,400 per year) because she could not document what her future expenses would be. Instead, Collection personnel allowed only $111 per month for healthcare and urged the taxpayer to claim higher rent expenses, since she lived with her parents who only charged her $169 per month (less than the standards) and would not be required to document the rent expense. Because she did not increase her rent expenses, Collection did not resolve her case. Appeals ultimately classified her account as currently not collectible.[28]

Standards Unrealistic for Some Taxpayers

The standards may reflect a reasonable estimate of what many taxpayers actually spend on the items that they include. However, they will be unrealistic for some taxpayers who have reasonable expenses that exceed the standards.[29] Housing and utility expenses, as the largest component of the standards, are illustrative. A 1996 IRS study of cases where the IRS applied the standards found that over 65 percent of taxpayers with mort-

[26] See David Kashihara and Kelly Carper, *Trends in National Health Care Expenses in the U.S. Civilian Noninstitutional Population*, 1997 versus 2002, Statistical Brief #86, Agency for Healthcare Research and Quality (June 2005) *available at* http://www.meps.ahrq.gov/papers/st86/stat86.pdf. Even though these expenses are not always born directly by individuals, they are passed on to individuals through premiums and co-payments. Per capita health care expenditures were $5,034 in 2001. *See* Staff of Comm. on Ways and Means, *2004 Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means*, Appendix C, C-1 (Comm. Print 2004). Although the Bureau of Labor Statistics Consumer Expenditure Survey shows that each consumer unit spent $2,416 on healthcare in 2003, this average may include consumers who do not report any healthcare expenditures. See US Department of Labor, US Bureau of Labor Statistics, *Report 986, Consumer Expenditures in 2003*, 3, 5 (June 2003) *available at* http://www.bls.gov/cex/csxann03.pdf.

[27] Even a bankruptcy court decision recently failed to properly take medical expenses into account when using the IRS expense standards. *See In Re Howe*, 319 B.R. 886, 891-892 (B.A.P. 9th Cir. 2005) (reversing and remanding the lower court).

[28] Letter from practitioner to TAS (Jun. 15, 2005); Automated Collection System (ACS) history (query conducted Oct. 12, 2005); Appeals Case Activity Record (query conducted Sept. 21, 2005); Integrated Data Retrieval System (IDRS) (query conducted Aug. 19, 2005).

[29] The standards were updated on Jan. 1, 2005. *See* IRS, *Collection Financial Standards, available at* http://www.irs.gov/individuals/article/0,,id=96543,00.html (Jan. 1, 2005)); IRS, *National Standards for Allowable Living Expenses, available at* http://www.irs.gov/businesses/small/article/0,,id=104627,00.html (Jan. 1, 2005).

gages exceeded the standards.[30] Although the IRS has since adjusted the housing and utility standards, they remain unrealistic for many.

Taxpayers who Recently Purchased or Refinanced their Homes

The local standards for housing and utilities may be unrealistic for taxpayers who have recently moved to a new area or refinanced their homes. Given the rising cost associated with housing, anyone who has recently moved is likely to be paying more than his or her neighbors (*i.e.*, more than the median costs reflected in the standards) because many of the neighbors acquired their homes when prices were lower. The standards may be particularly low for newcomers in communities that have little turnover or have experienced rapid appreciation.

Renters and Taxpayers Willing to Sell their Homes and Rent

The housing standards may also be unrealistic for renters in areas where the cost of renting exceeds the median mortgage payment, such as Atlanta and Dallas.[31] In these areas, a taxpayer whose mortgage payment exceeds the standard may find it difficult to reduce housing costs even if the taxpayer is willing to sell his or her home.

Taxpayers in Expensive Areas of Large Counties

Local standards, which apply on a county-by-county basis, are not likely to be realistic for an entire county. For example, year 2000 Census data shows that in Dallas County, Texas, median monthly home ownership costs for a given Census tract ranged from $534 to more than $4,000 (the upper bound measured by Census).[32] Although almost any geographic boundary is likely to create similar disparities, the IRS could estimate costs more accurately by using smaller geographic areas, especially in large counties or near cities where high- and low-cost areas are in close proximity.[33]

Taxpayers with Large Families

Housing and utility expense standards are also inadequate for families with more than four members. While the local standards recognize that housing and utility costs increase as family size increases up to four, they make no additional adjustments for larger families. The same housing and utility expense standard that applies to a family

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30 IRS National Office of Research and Analysis, *Allowable Living Expense Project, Evaluation of Current Allowable Living Expense Standards*, 8 (Oct. 1996). Tax debtors may be more likely to have other debts and to refinance their homes to take cash out to pay these debts, increasing their home mortgage payments above the standard.

31 *See, e.g.*, Sarah Max, *Why rent matters*, CNN/Money, Apr. 7, 2005, *available at* http://money.cnn.com/2005/04/05/real_estate/rentprices/ (last visited August 1, 2005).

32 U.S. Census Bureau, Census 2000 Summary File 4 (SF 4) - Sample Data, GCT-H9 Financial Housing Characteristics: 2000, *available at* http://factfinder.census.gov/servlet/GCTGeoSearchByListServlet?ds_name=DEC_2000_SF4_U&_lang=en&_ts=140610465359 (last visited August 1, 2005).

33 The Census data that the IRS uses to create the housing standards is available for smaller geographic areas. *Id.*

of four applies to a family of eight.[34] In contrast, the national standards allow an extra amount for each additional family member over four.[35] Families need more bedrooms (and spend more on utilities) as their family size increases. Thus, it makes sense to allow additional amounts for housing as they grow beyond four.[36] These deficiencies illustrate that no single standard will represent the expenses that every taxpayer will need to provide for basic living expenses.

Statistical Limitations

Another deficiency is that the standards are based on inexact projections of the average (or median) amounts that people spend on a given item. A number of the IRS standards are based on average annual expenditures reported by people who responded to a survey (*e.g.*, the CEX), as shown on Table 1.16.1 There is a 50 percent chance that the average expense by the overall population is greater than the survey average (or the IRS standards). Given the limited number of people who answered the survey, the magnitude of such underestimation may be significant. For example, there is a 16 percent chance that the average expenditures on food by families of four earning less than $10,000 is at least $432 per year more than the survey average, and a 2.5 percent chance that it is at least $864 per year more than the survey average.[37] Therefore, the standards rely on the IRS'Ss willingness to allow upward deviations from them in appropriate circumstances.

Standards Used as Expense Ceiling, Not Floor

While most taxpayers should have to reduce their expenditures in order to compromise a tax debt, taxpayers whose only expenditures are for basic living expenses should not. Indeed, the Code requires that the IRS design the standards "to provide that taxpayers entering into a compromise have an adequate means to provide for basic living expens-

34 Since the data that the expense standards are based on are for a family of 3, the IRS reduces the family of three standards by 15 percent to compute the standard for a family of two and increases it by 15 percent to compute the standard for a family of four or more. *See* SB/SE Research - Brooklyn/Hartford, *2005 Allowable Living Expenses*, Project No. 01.08.002.04, 3-6, 9, Appendix C (Dec. 2004).

35 *See* IRS, *National Standards for Allowable Living Expenses, available at* http://www.irs.gov/businesses/small/article/0,,id=104627,00.html (Jan. 1, 2005) (national standards for families with more than four persons). The Department of Housing and Urban Development's Fair Market Rent Schedule for apartments larger than four bedrooms adds an additional 15 percent to the four-bedroom rent for each extra bedroom. Department of Housing and Urban Development, *Proposed Fair Market Rents For Fiscal Year 2006 for Housing Choice, Voucher, Moderate Rehabilitation Single Room Occupancy and Certain Other HUD Programs*, 105 Fed. Reg. 32,402, 32,408 (Jun. 2, 2005).

36 The IRM provides that if "an unusually large family requires a housing cost that is not anticipated by the local standard" the taxpayer must provide substantiation and show that the expenses are necessary. IRM § 5.15.1.1(6) (May 1, 2004). We have heard from practitioners that both Compliance and Appeals have sometimes refused to allow additional housing expenses for families with more than four members.

37 Chief, SB/SE Research – Brooklyn / Hartford response to Information Request (Oct. 5, 2005). There is also a chance that the survey average exceeds the true average.

es."[38] The standards do not effectively serve this function for low-income taxpayers who cannot meet their basic living expenses.

Low Income Taxpayers Pay More

The national standards are regressive. That is, the standards for food, housekeeping supplies, apparel and services, and personal care decline as income declines.[39] Low income taxpayers are likely to live in places where the housing and utility standards are lower, but where food prices are higher.[40] Thus, the IRS is likely to require a low income taxpayer to pay a higher percentage of his or her income to the IRS to compromise a tax debt than a high income taxpayer with the same debt.

To be sure, there are reasons to allow taxpayers with higher incomes to claim higher necessary expenses. To some extent, the government should take a taxpayer's former lifestyle into account in determining what expenses are necessary.[41] High income taxpayers might not be willing to put forth the effort to maintain their income to repay the IRS if they have to reduce their standard of living to that of a low income taxpayer. Thus, higher expense standards for high income taxpayers may be justified on the basis that society benefits if high income taxpayers have an incentive to use their skills in the most productive manner. Allowing higher expenses for higher income taxpayers may also be justified on the grounds that a taxpayer's expenses actually increase as income goes up. For example, a debtor employed as a professional may need to spend more on clothing than a low income non-professional. However, such policies are inconsistent with the Code if low income taxpayers are unable to meet their basic living expenses under the standards.

Standards Provide No Safety Net

The IRS has no processes that automatically prevent it from depriving low income taxpayers of basic living expenses when it applies the standards. Rather, for local expenses, the IRS takes for itself any cost savings that enable taxpayers to spend less than a given

[38] IRC § 7122(c)(2). *See also* H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288 (1998) (stating that [under the Senate amendment] "[I]f the facts indicate that the use of scheduled allowances would be inadequate under the circumstance, the taxpayer is not limited by the national or local allowances.").

[39] In 1996, IRS research recommended that income stratification should be eliminated based on fairness concerns. IRS National Office of Research and Analysis, *Allowable Living Expense Project, Evaluation of Current Allowable Living Expense Standards*, 24 (Oct. 1996).

[40] *See, e.g.*, Phil Kaufman and Steven M. Lutz, Food and Rural Economics Division, U.S. Department of Agriculture, *Competing Forces Affect Food Prices for Low Income Households*, FoodReview (May-Aug., 1997) (concluding that low income taxpayers often face higher food prices because they tend to live in urban or rural areas where food prices are higher than in the suburbs). Low income taxpayers may face similar difficulties in limiting their vehicle operating expenditures to the standard amount if they live further from their jobs than average or if they have older cars that require more maintenance than average.

[41] *See, e.g.*, James Rodenberg, *Reasonably Necessary Expenses or Life of Riley?: The Disposable Income Test and A Chapter 13 Debtor's Lifestyle*, 56 Mo. L. Rev. 617, 634 (Summer 1991) (noting that some bankruptcy court rulings reason that the government should not impose its values on debtors when determining which expenses are necessary, but rather should allow the debtor some semblance of his or her former lifestyle, eliminating only luxuries).

expense standard. For expenses such as housing, utilities, and transportation, the IRS allows taxpayers the local standard or the amount actually paid, whichever is less.[42] For example, a taxpayer who "saves" money by being homeless and taking public transportation would be required to pay more to the IRS than a similarly situated taxpayer who has housing and automotive expenses.

Even for expenses included in the national standards, the IRS in many cases only allows expenses that taxpayers remember to claim on the financial statements they submit to the IRS.[43] Thus, nothing prevents the IRS from requiring payments that would force a taxpayer to live below the national poverty guidelines, for example, because they fail to list or properly document all of their necessary expenses.[44]

Demanding so much from a taxpayer that he or she is forced to live in poverty may increase the taxpayer's reliance on government assistance and reduce his or her potential to generate future income, which would be subject to tax. It is difficult to imagine how such demands will ultimately benefit the government.

If the IRS developed expense standards that it could use as a floor (*i.e.*, minimum expense levels that IRS personnel should allow without documentation), taxpayers whose expenses do not exceed the standards would not have to produce expense documentation for the IRS to analyze its collection alternatives. This reduction in paperwork could save both the taxpayer and the IRS time and money.

The burden of documenting basic living expenses may be particularly significant for low income taxpayers. Such taxpayers often need to spend money on items that they cannot afford like healthcare, housing or car repairs in excess of the standard. However, it may be difficult for them to produce documentation sufficient to satisfy the IRS until after they incur such expenses, which they may not be able to afford to do. Since taxpayers with incomes below certain poverty thresholds always forego various reasonable and necessary expenses, it serves little purpose for the IRS to require that the taxpayer identify and document those expenses. Thus, using standards as a floor, that is, assuming that some aggregate level of expenditure should be allowed without documentation, would empower IRS personnel to evaluate necessary (current or future) expenses more reasonably.

[42] IRM § 5.19.1.4.3.2(2) (Dec. 15, 2002); IRM § 5.15.1.7(4) (May 1, 2004).

[43] The IRM provides that IRS should "[A]llow taxpayers the total national standard amount for their income level." IRM § 5.15.1.8(2) (May 1, 2004). The IRM does not clarify that IRS allows the standard amount even if a taxpayer indicates that he or she spends less than the standard.

[44] Department of Health and Human Services, *Annual Update of the HHS Poverty Guidelines*, 70 Fed. Reg. 8,373, 8,374 (Feb. 18, 2005) (establishing a poverty guideline that varies only by family size and not by income).

Perception Standards Are Used to Reject Reasonable Collection Alternatives

There is a wide perception among practitioners that the standards are unreasonable and that the IRS applies them rigidly to reject offers and installment agreements.[45] Some practitioners tell TAS they have simply stopped advising clients to submit offers because they do not believe that the standards are reasonable or that the IRS will deviate from them even in appropriate cases. They complain that the IRS's increasing centralization makes it more likely for IRS personnel to apply the standards rigidly because they are not familiar with local economic conditions and are unlikely to ever deal with a given practitioner more than once.

When we asked practitioners and practitioner groups for examples of IRS's rigid adherence to the standards, we received examples of the IRS's general rigidity in determining an acceptable offer amount or an acceptable installment agreement payment schedule. Such examples included assuming that future income would be as high as current income regardless of age and health considerations, refusing to consider what a taxpayer would have to pay in bankruptcy even if bankruptcy was a realistic possibility, and failing to use penalty or interest abatement authority or authority to compromise based on effective tax administration.[46] General inflexibility is a problem that practitioners seem to associate with the expense standards, perhaps because a "standard" implies a one-size-fits-all rather than a case-by-case approach.

In some cases, it is difficult to determine whether the IRS rigidly applied the standards because the IRS does not always provide its financial analysis to taxpayers or their representatives.[47] Indeed, a review of recent TAS cases did not find as many clear-cut examples of the IRS's rigid adherence to the standards as we expected, given how often we hear from practitioners about this problem.[48] In some cases, TAS could not determine exactly how the IRS analyzed the taxpayer's financial situation based upon information contained in TAS's files. Thus, TAS could not effectively assess practitioner concerns.

[45] *See, e.g.*, Statement of Robert McKenzie on behalf of the American Bar Association Section of Taxation, Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means, *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=274 (Apr. 8, 2003); American Association of Attorney-Certified Public Accountants, *Position on Allowable Expenses, available at* http://www.attorney-cpa.com/i4a/pages/index.cfm?pageid=3321 (Jul. 31, 2002); T.D. 9007, 67 Fed. Reg. 48,025, 48,028 (July 23, 2002) (noting in the preamble: "According to the commenting party, IRS employees rarely depart from the national and local standards, which, in practice, serve as a 'cap' on expenses, rather than as a general guide to be applied based on the specific facts of a case."). TAS has received similar feedback from various members of the ABA, AICPA, and NAEA.

[46] Email from practitioner to TAS (June 16, 2005).

[47] Letter from a practitioner to TAS, 1 (June 15, 2005) (referencing ACS).

[48] TIGTA's review of 100 field offers closed in FY 2003 (50 accepted and 50 rejected but not appealed) found that 37 involved errors in financial analysis, 12 of which affected the outcomes. *See* Treasury Inspector General for Tax Administration, *Improvements Are Needed in the Timeliness and Accuracy of Offers in Compromise Processed by Field Offer Groups*, 2005-30-013, 12-14 (Dec. 2004). The report suggested that the errors were not attributable to unreasonable adherence to the standards. However, TIGTA's results were not statistically projected to the offer program as a whole.

Failure to Measure Erroneous Adherence to the Standards

More importantly, IRS management cannot reliably assess practitioner concerns that its employees fail to deviate from the standards in appropriate cases. The IRS has no quality measures that specifically track such failures. Instead, the IRS's Collection Quality Measurement System (CQMS) measures the number of deviations from the standards with insufficient documentation.[49]

The IRS's quality measurement system makes it more difficult for IRS employees to use common sense to get to the right answer when the standards are simply inappropriate. One practitioner told us that IRS Offer Examiners have complained to her that the standards are sometimes too limiting, but their managers and Area Counsel's office require the examiners to adhere to them.[50] If the IRS actually tracked the number of requests for a deviation and instances where employees inappropriately adhere to the standards, the incentive to adhere to the standards even in cases where deviation is appropriate might decline. Although it may be difficult for the IRS to objectively evaluate these subjective determinations, such measures would give IRS management the ability to evaluate practitioner concerns.

IRS COMMENTS

The IRS strongly disagrees that it uses unrealistic expense allowance standards. We believe that the current Allowable Living Expenses (ALE) standards ensure taxpayers a realistic standard of living during repayment of tax debt, and that existing policies and procedures ensure that the ALE are appropriately applied. As the National Taxpayer Advocate acknowledges in her document, there is no actual statistical trend or even a reasonable number of anecdotal examples where the standards have been rigidly or inappropriately applied; and no evidence that the standards are unfairly or inaccurately calculated. Rather, many of the National Taxpayer Advocate's assertions challenge the existence or formulation of the standards and require an explanation of the standard expense calculations and basic collection procedures.

Allowable Living Expenses

The Allowable Living Expenses (ALE) were formulated to be a reliable indicator of typical individual living expenses. They were created in response to taxpayer, practitioner and Congressional representative concerns to enhance the public perception of the fairness of the IRS collection process and eliminate the perception of capriciousness in determining the correct amount to collect without causing undue hardship. Many years of applying the standards to collection situations to arrive at fair and successful installment agreements, Offers in Compromise, and suspensions of collection due to financial hardship

[49] *See* IRM § 5.13.2.4.3 (May 31, 2005). The "correct case closing" measure may indirectly capture failures to deviate along with other errors, but does not provide a basis to determine whether IRS appropriately deviates from the guidelines. *See* IRM § 5.13.2.5.3 (May 31, 2005).

[50] Letter from practitioner to TAS, 3 (Aug. 5, 2005).

indicate that the ALE formulation meets this goal.

The ALE are used to reduce subjectivity in determining what a taxpayer may claim as basic living expenses necessary to avoid hardship when the taxpayer must delay full payment of a delinquent tax. The ALE provide a means to treat individual taxpayers fairly without giving an unfair economic advantage to tax debtors over citizens who pay voluntarily. However, the IRS does take into account other necessary expenses that are not covered by the ALE and IRS employees are directed to make exceptions to the application of the ALE when individual circumstances warrant.

The methodologies used in determining Allowable Living Expenses are statistically valid and reliable. The data sources currently in use are the U.S. Census Bureau, the Bureau of Labor Statistics (BLS), and the Board of Governors of the Federal Reserve System. Government sources are used to formulate the ALE because they are unbiased, utilize large samples, report regularly, and are not severely affected by short-term market fluctuations. These data sources are impeccable and widely relied upon by many branches of government and industry. The data contained in the ALE is formulated from statistically valid core data that is 100 % accurate at the time the information is collected. The IRS adjusts for market trends by using the Consumer Price Indices (CPI) as a basis and then projects anticipated inflationary increases to arrive at the figures on the current ALE.

Deviations from ALE and Additional Expenses

The Internal Revenue Manual (IRM) states: "National and local expense standards are guidelines. If it is determined that a standard amount is inadequate to provide for a specific taxpayer's basic living expenses, allow a deviation. Require the taxpayer to provide reasonable substantiation and document the case file." In other words, IRS employees are directed by the IRM to deviate from the ALE when warranted. It does not state or imply that the ALE will be used as a cap.

IRS employees do not rely solely on ALE standards to determine the universe of allowable expenses. The ALE standards are intended to include many, but not all, common living expenses. Expenses such as health care and child care, which are excluded from ALE, are listed as *specific expense* categories on the Form 433A, Collection Information Statement, in order to ensure that individual circumstances are taken into account. These expenses are allowed, subject to verification.

The IRS requires the taxpayer to provide proof of expenses in the same manner as any other creditor. It would be unreasonable and unfair to the compliant public at large for a collection officer to allow undocumented expenses in lieu of payment for delinquent tax. When information is verified, an exception to the ALE can be made, based on reasons of health, welfare, or production of income. The IRS does, however, allow the unchallenged claim of standard expenses to ensure basic needs are being met, and to promote fairness of application among tax debtors. In all cases, if a taxpayer is denied an installment agreement or an OIC, there is a safety net provided by the Independent

Administrative Review mandated by the Internal Revenue Code.

ALE Housing Expense

The ALE housing calculation is based first on Census data, increased by Bureau of Labor Statistics data, and Consumer Expenditure Survey (CE) for other selected homeowner costs; not the price of new homes. The Consumer Expenditure Survey (CE) is statistically valid and captures the real/actual expenses of the persons they survey. The figures are increased by using the appropriate Consumer Price Indices (CPI), and an additional projected CPI from July 1 of the preceding year through June 30 of the year in which the ALE will be used. The IRS recognizes that every geographic area has a variety of housing at different economic levels within the same commuting area. Collection employees have been given discretion to make exceptions to the application of the ALE based on individual circumstances

A significant concern leading to the creation of the ALE was tax debtors who purchased a luxury home with unpaid tax dollars, or who refinanced an existing home and diverted proceeds away from payment of delinquent taxes, with an expectation that the resulting mortgage payments would be allowed to reduce or eliminate the repayment of tax. Application of a standard fair housing allowance avoids sanctioning this conduct, which is highly detrimental to the perception of a fair tax system.

Additional Family Members

Based on gross monthly income, Appendix G of the 2005 ALE provides additional allowances for each member of a family over four. Indeed, no single standard will always accurately represent the needs of every family in all circumstances. The ALE is intended to provide unbiased information to be used as a guideline to determine what a reasonable expense may be.

Documentation Required for non-ALE Expenses

The ALE standards provide expense allowances for basic living necessities. A taxpayer is not required to document expenses for basic necessities, such as food, housekeeping supplies, apparel and services, and personal care products and services, because they are included in the standards. For expenses not included in the standards the IRS, as does any other creditor, requires the taxpayer to provide proof of expenses.

When a taxpayer fails to save proper documentation, IRS employees look to the last filed return for this information. Dependent information, health care costs, and childcare expenses are all reflected on filed returns. If an allowance for immediately foreseeable future expenses is necessary, revenue officers allow taxpayers a period of time to produce the applicable vendor quotes. Form 9297, Summary of Taxpayer Contact, is specifically designed for the purpose of follow-up documentation when the taxpayer cannot provide it initially.

In the unlikely event that a taxpayer fails to protect his or her own interests by neglecting to report expenses at the time a Collection Information Statement is taken, the taxpayer has the opportunity to revise the installment agreement at a later date by providing documentation of changed financial conditions or omitted expenses. The application of the ALE, coupled with the authority granted employees to deviate when necessary, ensures tax debtors a reasonable standard of living during the repayment period.

No evidence exists to support the belief that standards are rigidly applied when documentation of the need for an exception is provided. Indeed, The NTA notes in her report that "a review of recent TAS cases did not find as many clear-cut examples of the IRS's rigid adherence to the standards as we expected." In addition, in Footnote 48, although the National Taxpayer Advocate refers to a recent TIGTA review of 100 field offers that found 37 errors in financial analysis, she nevertheless notes that "the report suggested that the errors were not attributable to unreasonable adherence to the standards."

Finally, streamlined installment agreements are already available to those who owe less than $10,000 in tax and who can pay over a reasonable period of time. Documentation of expenses is not required for these agreements.

ALE Standards in Hardship Situations

Current IRS procedures clearly recognize true financial hardship situations. Application of the ALE to account resolution for taxpayers living on incomes below the poverty level is most likely to result in suspension of collection due to economic hardship. Current guidelines allow a taxpayer to be declared as currently not collectible due to economic hardship with an income of up to $84,000. Evidence that the standards do indeed already constitute a "floor" is demonstrated in the routine suspension of collection for taxpayers in economic hardship situations when the standards are applied.

The IRS does not provide allowances for certain expenses outside the ALE standards if those expenses are not in fact incurred. It would be unreasonable to allow an increased amount for the purchase of a home when the taxpayer currently rents, to purchase a car if the taxpayer currently rides the bus to work, or to provide an allowance for health care when the taxpayer's employer already pays the bill. A system that maintains the confidence of compliant taxpayers demands that tax debtors not be given allowances for major expenses they have not yet incurred, which would intentionally allow new purchases through the diversion of funds from the repayment of tax.

Quality Review System

The IRS's Embedded Quality (EQ) system performs broad based quality measurement to determine adherence to IRS policies. EQ does not exist to track to the level of such data as the outcome of individual taxpayer requests for deviation from the ALE. Allowable Expense attributes are combined with other success measures in a single EQ review standard, making it impossible to isolate requests for deviation from the overall standard. However, EQ examined Centralized Offer In Compromise (COIC) case review reports and comments for the period 01/01/2004 through 08/31/2005, to determine if available narrative information might suggest the number of instances where Collection employees failed to properly administer the ALE. Reviewers identified a total of two defects in the 542 cases reviewed. Both cases had comments. Both errors were in the taxpayers' favor, allowing the taxpayer smaller tax payments than were justified by the financial information presented by the taxpayers. The IRS does not believe that separate monitoring of failure to deviate from a single attribute within a particular standard is worthwhile without strong outside evidence that there is reason for concern.

No Evidence of Inflexible Application of Standards

The IRS has, in the past, asked for specific case examples that would demonstrate unfair or inflexible application of the ALE standards. In fact, OIC management partnered with the AICPA in an effort to identify situations where it appeared the ALE was applied in an unrealistic or rigid manner. A solicitation to the AICPA's approximately 500,000 members was sent earlier in 2005 to identify cases. Seven members responded to the solicitation and only one was about application of the ALE. The IRS appropriately resolved that matter, which concerned an employee failing to follow IRS guidelines.

In the absence of any data evidencing a problem, the expenditure of resources to create a system to track requests for deviations from ALE and IRS responses is not justified. If such problems were to arise, however, taxpayers already have the right to a review of requested deviations from the ALE through the IRS management chain of command, the Independent Administrative Reviewer, and the Taxpayer Advocate Service. Rejected Offers in Compromise can also be taken to Appeals. In spite of the many channels available for a problem to surface, it has not. As the National Taxpayer Advocate notes, there are very few anecdotal examples, and certainly no actual statistical trend, to indicate that the IRS is inflexibly applying the ALE standards.

Continued Refinement of ALE

In the interests of continual program improvement, and prior to the receipt of the present document from the National Taxpayer Advocate, the IRS had already indicated in its FY 2006 business plan the intention to explore the existence of additional data sources to further refine the annual formulation of the ALE. While we retain the highest confidence in the fairness and accuracy of the current formula and its application, we remain open to the identification of new, reliable data sources to inform our calculations and narrow the geographic scope of the ALE. We invite the National Taxpayer Advocate to identify specific data sources the National Taxpayer Advocate may feel would provide an opportunity to further perfect the ALE.

TAXPAYER ADVOCATE SERVICE COMMENTS

Standards Do Not Reflect What Each Individual Needs to Live

The TAS report describes some of the reasons why the standards do not reflect what every individual needs to provide for basic living expenses. Although the IRS largely acknowledges this fact, some of the statements in the IRS comments warrant a response.

Data Limitations

Although the IRS response states that the "data contained in the ALE is formulated from statistically valid core data that is 100% accurate at the time the information is collected," none of the survey data upon which the standards are based are "100% accurate" at any point in time. The Bureau of Labor Statistics provides the following caution on its web site with respect to the CEX data that the IRS uses:

> [The CEX surveys] are subject to two types of errors, nonsampling and sampling. Nonsampling errors can be attributed to many sources, such as differences in the interpretation of questions, inability or unwillingness of the respondent to provide correct information, mistakes in recording or coding the data obtained, and other errors of collection, response, processing, coverage, and estimation for missing data. The full extent of nonsampling error is unknown. Sampling errors occur because the survey data are collected from a sample and not from the entire population…. Caution should be used in interpreting the expenditure data, especially when relating averages to individual circumstances.... Expenditures by individual consumer units may differ from the average even if the characteristics of the group are similar to those of the individual consumer unit.[51]

Additional Family Members

The IRS response does not address our concern that the local standards for housing and utilities do not increase to account for families larger than four. The response simply states that "Appendix G of the 2005 ALE provides additional allowance for each family member over four." Appendix G of the IRS's 2005 Allowable Living Expenses Project lists only national standards, which do not include housing and utilities.

Housing Expenses

The IRS response justifies applying unrealistically low housing expense standards to taxpayers who purchased their homes more recently than their neighbors on the basis that they might otherwise purchase "a luxury home with unpaid tax dollars." However, the IRS requires taxpayers to offer their home equity to the IRS.[52] Further, if the assets are

51 *See* http://www.bls.gov/cex/csxfaqs.htm#q13 (last visited Dec. 21, 2005). The U.S. Census Bureau provides similar cautionary statements about their data. *See* http://www.census.gov/prod/cen2000/doc/sf3chap8.pdf (last visited Dec. 21, 2005).

52 *See, e.g.*, IRM § 5.8.5.3 (Sept. 1, 2005).

no longer available to pay the IRS because the taxpayer sold, gifted, transferred, or spent them on non-priority items or debts (called "dissipated assets"), the IRS pretends that the taxpayer still has such assets and adds them back when computing the taxpayer's ability to pay.[53] Thus, any asset dissipation concerns do not justify applying unrealistically low housing standards to all taxpayers.

Use of Standards in Hardship Situations

The IRS response states: "Evidence that the standards do indeed already constitute a 'floor' is demonstrated in the routine suspension of collection for taxpayers in economic hardship situations when the standards are applied." Evidence that the IRS sometimes determines, based on analysis using the standards, that collecting a tax debt would result in a hardship is not evidence that the standards constitute a reasonable "floor." In certain circumstances the IRS allows employees to determine that low dollar account balances owed by low income taxpayers should be classified as "currently not collectible" (CNC) based on economic hardship without always obtaining a full collection information statement.[54] If the IRS really applies the standards flexibly, the number of accounts that cannot be resolved using an installment agreement or offer in compromise should be few. Any evidence that IRS "routinely" uses its CNC authority seems most likely to suggest that it does not apply the standards flexibly. To be clear, we do not suggest that the IRS should require more documentation before making CNC determinations, but rather that it should require less documentation before allowing amounts necessary to provide for all basic living expenses, including expenses included in the local standards, when considering all of the collection alternatives.

Determining when to Deviate is Difficult, Subjective, and Not Encouraged

The IRS acknowledges that the standards only ensure that taxpayers can provide for basic living expenses if IRS employees deviate from them when necessary. The crux of the problem faced by IRS collection employees on a daily basis is how to determine when it is necessary or appropriate to deviate from the standards.

Existing Safeguards Not Always Adequate

The IRS does not always uses good judgment in its financial analysis, and existing safeguards, such as the IRS management chain or the IRS's Independent Administrative Review, are not always effective in correcting any lapses in judgment. Consider the following recent example.

> **Example:** A taxpayer with about $130 in net assets and $810 per month in Social Security Disability income submitted an offer-in-compromise. The

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[53] *See, e.g.*, IRM § 5.8.5.4 (Sept. 1, 2005).

[54] *See, e.g.*, IRM § 5.16.1.2.9 (Sept., 19, 2005). The IRS recently increased the amount of documentation required for such determinations. *See, e.g.*, IRM § 5.19.1.6.1.7(3) (Nov. 23, 2005); IMR § 5.19.1.4.3(2) (Nov. 23, 2005). We do not suggest that the IRS should require more such documentation, but rather that it should create a true floor.

taxpayer's income was about $9,720, just above the federal poverty guideline of $9,570, but the Offer Examiner allowed only $9,540 in expenses ($795 per month), which would reduce the taxpayer's disposable income below the federal poverty guideline.[55] Because the taxpayer's income was so low, the Examiner determined she was eligible for $80 per month in food support and added that amount as "imputed income" in determining what she could pay, requiring her to offer to pay the IRS four years of state food support program benefits for which she had not even applied.[56] The Examiner rejected the taxpayer's offer. His decision was approved by his manager and the IRS's Independent Administrative Reviewer.

Obviously, IRS procedures for reviewing this proposed offer rejection were ineffective. Although this particular taxpayer obtained assistance from TAS, not all taxpayers who need assistance from TAS seek our help.[57]

IRS Does Not Analyze Data in its Own Files

The IRS states in its response that the National Taxpayer Advocate acknowledges "there is no actual statistical trend or even a reasonable number of anecdotal examples where the standards have been rigidly or inappropriately applied." This statement is not correct. In fact, like many practitioners that we have spoken to or who have published articles about collection matters in the press (cited above), the National Taxpayer Advocate believes that the IRS often applies the standards rigidly. She believes TAS's national office has few clear-cut examples for the following reasons:

- Many taxpayers are self-represented and do not know that the IRS is supposed to deviate from the standards. Even if they know the IRS is not being reasonable, they may not object either because they assume there is nobody to hear their objection or because they fear retaliation. Neither TAS nor practitioners would be expected to see these cases.
- Taxpayers who are represented by practitioners or assisted by TAS are often able to get the IRS to deviate in the most egregious cases.

55 Department of Health and Human Services, *Annual Update of the HHS Poverty Guidelines*, 70 Fed. Reg. 8,373, 8,374 (Feb. 18, 2005).

56 Because the "imputed income" was multiplied by 48 months it added $3,840 to the minimum amount the IRS would accept. The examiner also allowed only $65 per month of the $100 that the taxpayer claimed to operate her friend's car, notwithstanding IRS guidance that no substantiation of such expenses is required unless they exceed the standard. IRS guidance provides: "Allow the full operating costs portion of the local transportation standard, or the amount actually claimed by the taxpayer, whichever is less. **Substantiation for this allowance is not required**." Memorandum From Acting Deputy Director, Compliance Policy, for Acting Deputy Director, Compliance Field Operations Deputy Director, Compliance Services, *IRM 5.15.1.3.2.2 Deviation For Offer In Compromise Processing – Local Standards: Transportation Expenses*, 1 (Jun. 25, 2004) (emphasis added), *incorporated into* IRM § 5.8.5.5.2 (Sept. 1, 2005).

57 *See* National Taxpayer Advocate 2004 Annual Report to Congress 356 (Most Serious Problem: Access to the Taxpayer Advocate Service). After TAS became involved in this case it was reopened and settled for about $130.

- It is difficult for everyone to agree that the IRS got it wrong in cases that are not egregious because determining whether a given expense is necessary involves subjective judgment.
- The IRS does not always provide its financial analysis to the taxpayer or to TAS, so it is impossible to determine why the IRS is rejecting the proposed collection alternative.

Assuming the IRS keeps records regarding financial analysis, it should have in its files all of the information it needs to determine whether rigid adherence to the standards is a problem for IRS personnel. It has many cases in its files that neither TAS nor any practitioner has worked on. However, the IRS has not bothered to analyze such cases in any statistically valid manner. Yet, the IRS points to the absence of statistically valid data as a reason not to create a quality measure that would detect a problem.

Moreover, the IRS's response completely dismisses the concern that IRS employees often rigidly adheres to the standards, which has been raised by the ABA and others in Congressional testimony as well as those raised by various practitioners on an ongoing basis.[58] Such consistent concerns raised by well-respected practitioners and practitioner groups should not be ignored.

Easier for IRS Collection Employees Not to Deviate

IRS guidance makes the job of IRS employees who want to exercise good judgment in deviating from the standards more difficult than it needs to be. The IRS response states that the IRM "does not state or imply that the ALE will be used as a cap." In fact, although we notice that the IRS has recently removed the "cap" language from its website, IRM § 5.19.1.4.3.2(2) (Dec. 15, 2002) currently states:

> Unlike the national standards, the local standards for housing, utilities, and transportation serve as a cap. The taxpayer is allowed the local standards or the amount actually paid, **whichever is less**." (Emphasis in original.).

IRM § 5.15.1.7(4) (May 1, 2004) provides similar guidance.[59] Neither section discusses any exception to the definitive statement that IRS employees may not allow more than the local standards for housing and utilities. Separate sections of the IRM state in more general terms, that the IRS may deviate from the standards if the taxpayer provides sub-

[58] *See, e.g.*, note 4, *supra*; Robert Zarzar, *AICPA Submits Survey Results On Offer In Compromise Program*, 101 Tax Notes 346 (Oct. 15, 2003) (providing survey results reflecting the "nearly unanimous" opinion of surveyed AICPA members that the IRS is intentionally looking for reasons to reject offers). In September 2005 at the American Bar Association Tax Section meeting at the Low Income Taxpayer Committee discussion, which IRS representatives participated in, practitioners repeatedly described examples of how the IRS's application of the standards harmed their clients.

[59] See also IRM § 5.19.1.4.3.4(4) (Dec. 15, 2002) (stating: "Under ownership costs, separate caps are provided for a one-person household and, if a second car payment is allowed, a two or more person household."); IRM § 5.8.5.5.2(3) (Sept. 1, 2005).

stantiation and shows that the expenses are necessary.[60] However, if general and specific guidance appear to conflict, most people expect the most specific guidance to control. At best, IRS guidance is confusing, and some IRS personnel may be unaware that they can allow an upward deviation from the local standards.

IRS quality standards also make it difficult for IRS employees to deviate in appropriate circumstances. The decision to allow an upward deviation is a subjective decision that is easy for others to find fault with. IRS quality measures do not reflect an error when an IRS employee fails to allow an upward deviation without analyzing documentation (which is more work), but will reflect an error if the employee allows an upward deviation without sufficient documentation. Indeed, the IRS response finds fault with two IRS employees who exercised judgment to allow an upward deviation without adequate documentation. Yet, the IRM does not spell out exactly when an upward deviation from the standards is appropriate and will not be questioned by management.[61] In such an environment, IRS employees are not likely to allow an upward deviation from the standards except in the most egregious cases.

Documentation for Expenses Omitted from the Standards

The IRS response minimizes the difficulty of obtaining current and future expense documentation for items omitted from the standards or included in the local standards.[62] The IRS imposes significant costs on taxpayers and on IRS collection employees when it requires them to obtain and analyze extensive documentation. Even taxpayer costs are likely to be borne by the IRS since they (*e.g.*, the cost of assistance in submitting an offer) will likely reduce what the IRS can collect. Is it really necessary for the IRS to require taxpayers to submit a quote for future expenses that a taxpayer is not actually incurring, such as housing, health, or child care? In many cases the taxpayer is in no better position than the IRS to determine what future expenses might be. Disallowing all expenses for housing, utilities, and transportation expenses in the absence of documentation may actually encourage taxpayers, who would otherwise live frugally and use every extra dollar to pay their taxes, to purchase a new car and move to a better apartment before discussing collection alternatives with the IRS, as long as such expenditures can be justified.

The IRS response also suggests that other creditors require similar expense documentation. We know of no other creditor that requires current and future expense documentation similar to that required by the IRS. A member of the National Taxpayer Advocate's staff recently obtained a home mortgage without providing the lender with any expense documentation. The lender based its decision solely on a credit report, current income, assets, and pre-existing debts.

60 *See, e.g.*, IRM § 5.15.1.7(7) (May 1, 2004) and IRM § 5.8.5.5.1(2) (Sept. 1, 2005).

61 Although the IRM sometimes mentions items of documentation, such as bank statements, it could be more specific in describing what sacrifices a family should not be expected to make. *See e.g.*, IRM § 5.15.1.1(6) (May 1, 2004); IRM § 5.8.5.2.2 (Sept. 1, 2005).

62 To be clear, we agree that taxpayers should document current expenses that exceed the standards.

RECOMMENDATIONS

The National Taxpayer Advocate's recommendations are as follows:

Improve the Standards

- Develop local expense standard amounts that IRS personnel can allow without documentation. The IRS should consider allowing taxpayers to retain enough net income to stay out of poverty, as measured by the federal poverty guidelines (or some reasonable percentage above them), without documentation (*i.e.*, a floor). The IRS should also consider whether other measures, such as the "Self-Sufficiency Standard" used by a number of states and localities, could be used as a floor.[63]
- Develop expense standards for every major taxpayer expense category, including healthcare expenses for both insured and uninsured, health insurance costs and childcare (or eldercare). The footnotes in the TAS report identify a number of data sources that the IRS could explore.
- Reduce the geographic area covered by each standard so that they are more likely to reflect actual expenses in a given area.
- Provide an additional amount under the local standards for each additional family member even if the family has more than four members.

Update Guidance and Provide Training

- Revise IRM guidance to eliminate any suggestion that IRS personnel cannot allow expenses in excess of the standards.
- Publicize these changes and train all IRS collection personnel to be flexible in allowing upward deviations from the standards in appropriate cases.

Revise Quality Measures and Conduct Research

- Sponsor research into whether IRS collection employees are allowing an upward deviation from IRS expense standards in all appropriate cases, including focus groups with taxpayer representatives and Low Income Taxpayer Clinics. Based on the research results, the IRS should revise its quality measures (CQMS and EQ) to track how often the IRS employees erroneously fail to allow an upward deviation from the expense standards.
- Change the IRS quality measure that tracks the number of deviations from the standards with insufficient documentation. Instead, the quality measure should focus on whether the IRS closed the case, regardless of the outcome, without making a sufficient effort to obtain and analyze relevant documentation.

63 *See* **http://www.sixstrategies.org/sixstrategies/selfsufficiencystandard.cfm**.

PROBLEM
TOPIC #17

MOST SERIOUS PROBLEM: INADEQUATE TAXPAYER SERVICE TO EXEMPT ORGANIZATIONS, RESULTING IN UNNECESSARY PENALTIES

RESPONSIBLE OFFICIAL

Steven T. Miller, Commissioner, Tax Exempt and Government Entities

DEFINITION OF PROBLEM

Most tax exempt organizations are very small entities with meager resources that operate locally with modest budgets and rely on the services of volunteers. At the same time, tax-filing requirements for exempt organizations are multifarious and quite complex. Failure to meet these requirements results in automatic assessment of penalties. This combination of volunteer labor, complex requirements, and automatic penalties often results in (1) unintentional and expensive filing mistakes by small exempt organizations and (2) the expenditure of IRS resources both initially to assess penalties for these mistakes and later to abate these penalties when the mistakes are corrected. From 1992 through September 2004, more than 74.5 percent of assessed daily delinquency penalties (DDPs) (525,322 penalties totaling more than $1.7 billion) were later abated because exempt organizations supplied missing information and demonstrated reasonable cause for their initial errors or omissions.[1]

This problem is further exacerbated by the exempt organizations' inability to contact the IRS for guidance and the IRS's limited outreach resources. In fact, the likelihood of an exempt organization accessing the IRS by phone for guidance is about 60 percent.[2] The costs and burdens associated with assessing and later abating penalties could be reduced or avoided if exempt organizations understood their filing obligations and the associated procedures well enough to avoid correctible mistakes. The IRS has an obligation to help these organizations understand their federal tax responsibilities.

ANALYSIS OF PROBLEM

Background

Exempt Organizations

Under IRC § 501, certain specified organizations are exempt from federal taxation. This Code section lists at least 28 different types of "exempt organizations." The most common are charitable, religious and educational organizations, civic associations, labor organizations, business leagues, social clubs, fraternal organizations, and veterans' organizations.[3] The vast majority of exempt organizations are formed for "religious, charitable, scientific, testing for public safety, literary, or educational purposes" under § 501(c)(3). The term "exempt organization" as used in this section of the Annual Report to Congress

1 Tax Exempt and Government Entities (TE/GE) Division, Ogden Campus Program Analyst, DDP Stats (April 22, 2004); TE/GE, FY 03 & 04 Penalty Stats (July 26, 2005); IRC § 6652(c)(2); IRM § 21.3.8.13.3.5, Reasonable Cause for Penalty Abatement (10/01/2005).

2 TE/GE Cincinnati Call Center, *Call Data Summary FY 2005*.

3 TE/GE, Exempt Organizations, Training 4325-002 (Rev. Feb. 2004) at 2-1.

refers to an organization described in IRC § 501(c)(3) unless otherwise noted.

Exempt Organization Demographics

As of fiscal year (FY) 2004, there were 1,680,061 tax exempt organizations formed under IRC § 501. Over 1,010,365 were formed for religious, charitable, and similar activities under § (c)(3). The next largest categories, in order, were social welfare organizations formed under (c)(4) (138,193), business leagues formed under (c)(6) (86,054), social and recreational clubs formed under (c)(7) (70,422), fraternal beneficiary society (c)(8) (69,798) and labor and agricultural organizations formed under (c)(5) (62,561).[4] In tax year 2001, 64 percent of exempt organization returns were filed by § 501(c)(3) organizations with assets of less than $500,000. These organizations held only one percent of total assets of all tax exempts.[5] TE/GE reports roughly half of exempt organizations have only volunteer staffs and another third have fewer than 10 employees. Many organizations, particularly these smaller groups, lack professional accounting staffs and rely on volunteer support to manage their interactions with the IRS.[6]

More than three-quarters of the assets in the nonprofit sector are held by about four percent of total nonprofit organizations, such as hospitals, higher education institutions, private colleges, and universities. These large organizations also account for a disproportionate share of expenses and employment in the sector.[7] This data indicates that there are few large, financially sophisticated exempt organizations. Most exempt organizations are very small entities with meager resources, operating locally with modest budgets and volunteer labor. The volunteers who run these organizations are generally not tax or financial professionals, and are not likely trained in exempt organization tax compliance issues. Many of these volunteers may have little if any experience in tax, accounting or financial matters of any kind.[8] Thus, it is important for the IRS to understand the needs of this customer base and direct adequate resources to effectively serve the small exempt organization population.

The IRS and Exempt Organizations

The IRS's role is different for exempt organizations than for other taxpayers. For these organizations, the IRS actually serves three separate and important roles. First, the IRS acts as an overseer in determining if an organization meets federal tax exemption requirements. After making this determination, the IRS shifts to its second role: that of regulator. In this capacity, the IRS needs timely and accurate information to determine

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[4] IRS Data Book 2004, Table 22-*Tax Exempt Organizations and Other Entity Listed on the Exempt Organization Business Master file, by Type of Organization and Internal Revenue Code Section, Fiscal Year 2001-2004*.

[5] Paul Arnsberger, *Charities and Other Tax-Exempt Organizations* 130 (2001).

[6] Tax Exempt & Government Entities, *Strategic Assessment* 3 (FY 2005).

[7] *Nonprofits & Government: Collaboration and Conflict*, The Urban Institute Press, Elizabeth T. Boris and C. Eugene Steuerie editors 10 (1999).

[8] *Nonprofits & Government: Collaboration and Conflict*, The Urban Institute Press, Elizabeth T. Boris and C. Eugene Steuerie editors 7 (1999),; Tax Exempt & Government Entities, *Strategic Assessment* 3 (FY 2005).

if an organization is complying with the rules that enable it to be exempt from tax. Finally, because the majority of exempt organizations are small and volunteer based, the IRS also has a third role: educator and advisor. Here, the IRS helps exempt organizations understand tax exemption rules and filing requirements. The IRS formally recognizes these various roles in the mission statement for the IRS Tax Exempt and Government Entities Division (TE/GE).

> To provide Tax Exempt and Government Entities customers top-quality service by helping them understand and comply with applicable tax laws and to protect the public interest by applying the tax law with integrity and fairness to all.[9]

As an overseer and regulator, the IRS has recently expressed concern about certain exempt organizations involved in abusive tax shelters.[10] Such activity is certainly a problem that cannot be ignored, and we commend the IRS's attention to this issue. But the vast majority of exempt organizations are small operations that do legitimate, meaningful work. The IRS, therefore, cannot abandon its educator/advisor role in its efforts to address abusive charities.

IRS Resource Allocation

The IRS chronically understaffs and underfunds exempt organization customer service and assistance (such as customer service phones and outreach and education efforts). Table 1.17.1 shows TE/GE compliance and customer service staffing from FY 2003 through FY 2005.

[9] http://www.irs.gov/irs/article/0,,id=100971,00.html.

[10] Tax Notes Today, Daily Tax Report; Tax, Budget & Accounting, *Exempt Organizations: IRS Shifting Enforcement Actions Regarding Tax-Exempt Groups To Crack Down On Abuses* (May 23, 2005).

TABLE 1.17.1, TE/GE STAFFING IN FTE:[11] FY 2003 – FY 2005[12]

Staff Position	FY 2003	FY 2004	FY 2005
Exempt Organization (EO) Compliance	394	378	472
Total Enforcement	**394**	**378**	**472**
Taxpayer Assistance[13]	97	95	94
Customer Education and Outreach (CE&O) Staff	7	8	7
Non-CE&O Staff time applied to CE&O education and outreach[14]	9	11	7
Total Taxpayer Assistance and EO Outreach and Education[15]	**113**	**114**	**108**

In FY 2005, TE/GE EO Compliance programs had 472 Full Time Equivalent (FTE) staff positions. In contrast, staffing dedicated to customer service and EO outreach and education for FY 2005 was 108 FTE staff positions. Customer service staff accounts for only 18.9 percent of total EO enforcement and customer service staffing. Outreach and education staffing declined slightly between 2003 and 2004, yet the number of exempt organizations grew by nearly 40,000.[16] A consequence of these staffing decisions is less guidance for exempt organizations.

The Exempt Organization Filing Requirements are Complex

Once an organization is granted tax exempt status, it is required to file annual information returns with the IRS. Numerous rules dictate which forms a particular tax-exempt group must file. In its overseer and regulator roles, the IRS has a legitimate need for timely and accurate information.

11 Full Time Equivalent.

12 Information provided by Director, TE/GE Planning (Dec. 6, 2005) from financial and technical time reporting systems.

13 "Taxpayer Assistance" includes toll-free telephone and correspondence work. This staff is organizationally independent of TE/GE's EO division, but over 90 percent of its work is related to exempt organizations. Information from Director, TE/GE Planning (Dec. 6, 2005).

14 TE/GE also used education and outreach staff to perform outreach work equal to 7 full time staff. TE/GE non-CE&O staffing numbers calculated by dividing direct hours (provided by TE/GE in response to Information Request #2) by Full Time Equivalent staffing hours per year and rounded to the nearest whole number. The numbers in Table 1.17.1 represent total direct hours worked by several different TE/GE employees and have been rounded. The numbers do not indicate that there were, respectively, 13, 10 and 7 actual non-CE&O staff dedicated to CE&O full time for the applicable years.

15 TE/GE also used non-education and outreach staff to perform outreach work equal to seven full time staff in FY 2005. The numbers in Table 1.17.1 represent total hours worked by several different TE/GE employees and have been rounded. The numbers reflect time applied to these activities and do not necessarily equate to 9, 11 and 17 actual non-CE&O staff dedicated to CE&O full time for the applicable years.

16 SOI Table 22, *Tax-Exempt Organizations and Other Entities Listed on the Exempt Organization Business Master File, by Type of Organization and Internal Revenue Code Section, Fiscal Years 2001-2004* at http://www.irs.gov/pub/irs-soi/04db22eo.xls

Although exempt organizations are not required to pay income tax, they are generally required to file one or more of the following forms:[17]

Form 990

Exempt organizations with annual gross receipts of $100,000 or more, or total year-end gross assets of $250,000 or more, must file Form 990, *Return of Organization Exempt From Income Tax*.[18] Form 990 is six pages long and has a 46 page instruction book.19 Form 990 also requires two schedules: Schedule A, *Allocation of Expenses*, which is six pages long and has 13 pages of instructions; and Schedule B, *Balance Sheet*, which is at least two pages long with another two pages of instructions.[20] The estimated time to prepare and complete Form 990 and Schedules A and B is more than 214 hours –almost 27 days for one person working eight hours a day.[21]

Form 990-EZ

An exempt organization that is required to file an information return can file Form 990-EZ, *Short Form Return of Organization Exempt from Income Tax*, if the organization's gross receipts during the year are less than $100,000 and its total assets at the end of the year are less than $250,000.[22] Form 990-EZ filers must also file Schedules A and B. The estimated time to prepare and complete Form 990-EZ is 55 hours and 39 minutes.[23] This estimate, however, does not include preparing and completing the required Schedules A and B, which add another 78 hours. Thus, it would take one person working eight hours a day more than 16 days to prepare and complete the "short form." Further, the gross income and total asset thresholds are not adjusted for inflation, so it is likely that more tax-exempt organizations will be required to file the longer Form 990 in the future.

Form 990-T

Tax-exempt organizations are required to file Form 990-T, *Exempt Organization Business Income Tax Return*, if the organization has income from unrelated business activities of

[17] Under IRC § 501(c)(3) Certain tax exempt organizations are generally not required to file Form 990, *Return of Organization Exempt From Income Tax, or Form 990 EZ, Short Form Return Exempt From Income Tax*, such as churches and certain other religious organizations, as well as organizations with gross receipts less than 25,000. These organizations may, however, have other filing requirements.

[18] IRS Form 990, *Return of Organization Exempt from Income Tax* (2004).

[19] *Id.*

[20] IRS Form 990, *Return of Organization Exempt from Income Tax* (2004).

[21] 2003 Instructions for Forms 990 and 990-EZ 44, *Return of Organization Exempt from Income Tax.*

[22] Even if an organization meets the requirements to file a Form 990-EZ, it can still file a Form 990 instead, if it so chooses.

[23] Instructions for Forms 990 and 990-EZ 44(2003).

$1,000 or more.[24] This form is four pages long, with 49 lines, five parts, ten schedules and 20 pages of instructions.[25] Form 990-T filers must also file Schedule B. The estimated time to prepare and complete Form 990-T is approximately 142 hours (not including the nearly eight hours required to prepare and complete Schedule B).

Employment Tax Forms 941 and 940

Exempt organizations that withhold income tax from wages or must pay social security or Medicare tax must file a Form 941, *Employer's Quarterly Federal Tax Return*, each quarter.[26] Exempt organizations with employees must also file Form 940, *Employer's Annual Federal Unemployment Tax Return*, to report annual Federal Unemployment Tax Act (FUTA) tax.27 The estimated time to prepare and complete each Form 941 is 15 hours.[28] The estimated time to prepare and complete Form 940 is approximately 19 hours.[29]

As Table 1.17.2 demonstrates, exempt organizations must spend substantial time complying with their federal tax filing obligations. Not all organizations are required to file every return listed below. As an example, however, a Form 990 filing organization with a few employees and more than $1,000 in unrelated business income could spend over 435 hours a year complying with its federal tax filing requirements – keeping one person engaged full-time for nearly 11 work weeks. Even an exempt organization filing the "short" Form 990-EZ, with no employees or unrelated business income, could spend more than 130 hours complying with its federal tax filing obligations – a task one full-time person would need more than 16 work days to complete.

[24] Form 990-T, *Exempt Organization Business Income Tax Return*, Cat. No.11292J (2003). IRC § 512(a)(1) Unrelated Business Income is income from a trade or business that is regularly carried on by an exempt organization and that is not substantially related to the organization's exempt purpose or function. Although an organization is tax exempt, it is subject to the information reporting requirements of IRC § 6033. *See* IRS Pub. 598, *Tax on Unrelated Business Income of Exempt Organizations 19* (2004).

[25] Instructions for Form 990-T, *Exempt Organization Business Income Tax Return* 19 (2004), 19.

[26] IRS Form 941, *Employer's Quarterly Federal Tax Return* (Rev. Jan. 2005).

[27] IRS Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return* (Rev. 2004). The earliest version of this form on the IRS Forms site is 1938. http://publish.no.irs.gov/catp.cgi?catnum=11234.(Last viewed July 14, 2005); Instructions for Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, consists of 8 pages.

[28] IRS Form 941, *Employer's Quarterly Federal Tax Return* (Rev. Jan. 2005).

[29] 2004 Instructions for Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return* 8.

TABLE 1.17.2, ESTIMATED TIME FOR COMPLETING FORM 940, 941, 990 AND RELATED SCHEDULES

Form	Record-keeping	Learning about the law or Form	Preparing the Form	Copying, assembling, and sending to IRS	Total
990	98 hr., 31 min.	15 hr., 4 min	21 hr., 4 min	1 hr., 4 min	135 hr., 43 min.
990-EZ	29 hr., 10 min	11 hr., 33 min	14 hr., 24 min	32 min	55 hr., 39 min.
Schedule A (990 or 990EZ)	50 hr., 42 min	9 hr., 26 min	10 hr., 40 min	N/A	70 hr., 48 min.
Schedule B (990, 990EZ, or 990-PF)	4 hr., 46 min	1hr., 23 min	1 hr., 31 min	N/A	7 hr., 40 min.
990 T	67 hr., 26 min.	27 hr., 10 min.	43 hr., 25 min.	4 hr., 1 min.	142 hr., 2 min.
940	15 hr., 32 min.	1 hr., 23 min.	1 hr., 57 min.	N/A	18 hr., 52 min.
941	12 hr., 39 min.	40 min	1 hr., 49 min.	16 min.	15 hr., 24 min.

Penalties on Exempt Organizations

In its oversight and regulatory roles, the IRS has a legitimate need for timely and accurate information from exempt organizations. Moreover, it is appropriate for the IRS to assess penalties on organizations that do not comply with the requirements for tax exempt status. Thus, if an organization does not file the proper forms accurately and timely, the IRS may assess penalties or even revoke tax exempt status. However, the combination of complex filing requirements and unsophisticated volunteers preparing and filing returns can, and often does, result in mistakes or omissions. Thus, through its advisory role, the IRS must provide exempt organizations with clear and concise guidance on how to properly complete and file these returns.

Daily Delinquency Penalties

IRC § 6652(c)(1)(A) imposes a $20 per day penalty (up to the lesser of $10,000 or five percent of the organization's yearly gross receipts) on exempt organizations filing late information returns, or filing returns with missing or incomplete information.[30] For exempt organizations with annual gross receipts exceeding $1 million, the penalty is $100 a day (up to $50,000). The IRS assesses this penalty for each day an organization fails to file a correct and complete return. Table 1.17.3 shows both the number and amounts of Daily Delinquency Penalties (DDPs) assessed and abated from 1992 through 2004.

[30] The Information Return Items were developed from 26 USCS 6033 and documented in a 1981 General Counsel Memorandum (GCM 38760). TE/GE IRI guidelines are listed in the following:
IRM § 3.11.12, Exempt Organization Returns, Returns and Document Analysis;
IRM § 3.12.12, Exempt Organization Returns, Error Resolution; and
IRM § 3.12.246, Exempt Organization Returns, Error Resolution.

TABLE 1.17.3, DAILY DELINQUENCY PENALTY ASSESSMENTS AND ABATEMENTS[31]

Year	Number Assessed	Number Abated	Percent	Assessment Amount	Abatement Amount	Percent
1992	43,718	30,705	70.2	$54,467,528	$44,073,258	80.8
1993	44,120	31,322	71.0	$56,023,973	$45,581,154	81.4
1994	51,266	40,113	78.2	$63,018,363	$52,752,590	83.7
1995	50,061	36,084	72.1	$64,733,891	$52,176,966	80.6
1996	52,368	35,997	68.7	$69,305,909	$53,578,007	77.3
1997	58,664	39,996	68.2	$70,922,727	$55,625,492	78.4
1998	73,161	54,761	74.8	$146,113,469	$122,338,729	83.7
1999	54,938	39,631	72.1	$155,482,161	$129,424,080	83.2
2000	61,065	43,959	72.0	$175,478,613	$145,588,460	83.0
2001	57,451	39,691	69.1	$165,128,263	$129,909,678	78.7
2002	69,575	45,470	65.4	$207,557,338	$149,111,426	71.8
2003	74,249	41,690	56.1	$229,901,830	$138,919,162	60.4
2004	81,154	45,903	56.6	$235,925,748	$143,219,698	60.7
Total	**771,790**	**525,322**	**68.1**	**$1,694,059,813**	**$ 1,262,298,700**	**74.5**

Table 1.17.3 indicates that since 1992, the IRS assessed penalties only to later abate them at the rate of 68.1 percent of all DDPs and 74.5 percent of the $1.7 billion assessed. In the last 13 years the IRS has doubled the number of DDP penalties it assessed against exempt organizations, from 43,718 in 1992 to 81,154 in 2004. However, the IRS has taken a tougher stance in the abatement of these penalties in the last few years, reducing the amount abated from 83.7 percent in 1998 to 60.7 percent in 2004.

IRS Penalty Processes and Procedures

When an exempt organization does not file a timely return, or files one with incorrect or incomplete information, the IRS assesses the DDP for each day the return is late or information is missing.[32] In addition, the IRS sends written correspondence to the organization to try to obtain the correct information or missing return.[33] This practice can result in assessed penalties even when the IRS is still asking for the missing information and the organization supplies it.[34] To have the penalties abated, the exempt organiza-

[31] Enforcement Revenue Information System (ERIS) for EO Returns, 1992 – 2004 DDP assessments and abatements.

[32] Up to a maximum of the lesser of $10,000 or five percent of the organization's yearly gross receipts; or, for organizations with annual gross receipts exceeding $1 million, $50,000. IRC § 6652(c)(1)(A). Internal Revenue Manual - Exhibit 3.12.12-12 through Exhibit 3.12.12-16 are "Incomplete Return Items (IRIs)". For non-IRI correspondence issues, see Exhibit 3.12.12-22.

[33] Letter 2698C, *Form 990 – Request for Missing Information*, for missing or incorrect information and Letters CP 411, *EOMF First Return Delinquency Notice*, and CP 414, *EOMP Second Return Delinquency Notice*, for missing returns. IRM § 3.11.12.1.21 (01-01-2006); IRM 20.1.8.2.1; IRC § 6652(c)(2).

[34] IRM § 20.1.8.2.1 Failure to File Certain Information Returns; IRC § 6652(c)(2.).

tion must show reasonable cause for filing a late or incomplete return.[35]

Common Filing Errors

The combination of complex filing requirements and unsophisticated volunteers is a recipe for unintentional errors and inadvertent noncompliance. Table 1.17.4 shows the most common Form 990 and 990-EZ filing errors.

TABLE 1.17.4, THE MOST COMMON FORM 990 AND FORM 990-EZ FILING ERRORS[36]

Form 990	Form 990-EZ
Schedule B is missing or incomplete.	Schedule B is missing or incomplete.
Schedule A missing or incomplete.	Schedule A missing or incomplete.
Missing signature.	Request to file Form 990 (total assets more than $250,000).
Part IV-A, Schedule A (support schedule), missing or incomplete.	Request to file Form 990 (gross receipts more than $100,000).
Part IV missing or incomplete. (Reconciliation of revenue/expenses.)	Missing signature.
Clarification of subsection (request copy of determination letter)	Clarification of subsection (request copy of determination letter).

This table demonstrates that the most frequent exempt organization filing errors appear to be attributable to inadvertent or clerical mistakes, including failing to file required schedules or filing an incorrect form. For instance, the two most common errors for both Form 990 and Form 990-EZ are missing or incorrect Schedules A and B. These errors are most likely due to exempt organizations being unaware that they are required to file Schedules A and B.

At one time, the IRS reported not only the common filing errors, but also the frequency of each one (the IRS no longer reports error frequency information). When the IRS last reported error frequency in FY 1998, more than 50 percent of all Form 990 and Form 990-EZ errors were attributable missing or incorrect Schedules A.[37] Schedule B, *Schedule of Contributors*, was added for filing year 2000, and now missing Schedules B has moved ahead of missing Schedules A on the common error list. Because missing Schedule errors are the most common From 990 and Form 990-EZ errors, it is apparent that the Form 990 and Form 990-EZ instructions, or other IRS materials, do not make the

[35] IRC § 6652(a)(3); IRM § 3.12.12.2.6.8 - Reasonable Cause; IRM § 20.1., Rev. Proc. 79-8, Policy Statement P-2-7, P-2-9, and P-2-11.

[36] Most Common Reasons the IRS May Need to Contact You, at http://www.irs.gov/charities/article/0,,id=96359,00.html.

[37] IRS, *Common Errors Found on Form 990 and Form 990 EZ*, at http://www.qual990.org/common_errors.html, 1998 tax year information.

Schedules A or B filing requirements sufficiently clear.[38]

Another common mistake is filing a Form 990-EZ instead of a Form 990. This error could occur when a small tax-exempt organization meets the Form 990-EZ gross income threshold, but not the year end total asset threshold (error number three on the Form 990-EZ list). This situation could easily come about when a small exempt organization owns appreciated assets, such as real estate. In fact, of the 360,000 tax-exempt entities that filed Forms 990 for tax year 2003, about 20 percent reported income less than $25,000 and about 50 percent reported income less than $100,000.[39] This data suggests that many (if not most) tax-exempt organizations are required to file the longer Form 990 solely because of the total asset threshold.[40]

Even though these errors are inadvertent, the organizations at fault are subject to DDP assessments. The IRS assesses the penalty, and the organization must show that the errors were due to a reasonable cause. The IRS must then expend resources to determine if the errors were "reasonable" and abate the associated penalties, as appropriate.

IRS Approach to the Problem

The IRS recognized that exempt organization DDPs were a problem and undertook a study to research the problem. The TE/GE Customer Account Services (CAS) analyst staff at the IRS campus in Ogden, Utah reviewed a sample of penalty cases in October 2003 to determine the common types of Information Return Item (IRI) errors.[41] Consistent with the IRS reported common error information, the study found that

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[38] The instructions informing the exempt organization that the Schedule A and B is required read as follows: "Schedule of Contributors. Schedule B (Form 990, 990-EZ, or 990-PF) is used by all organizations required to file Form 990, 990-EZ, or 990-PF, to provide the contributor information required for line 1 of those forms."

[39] SOI strata of asset and income data for Form 990 filers for 2003 (tax periods 200301 through 200312). Note that Form 990 entities with gross receipts less than $25,000 and churches are generally not required to file Form 990, Schedule A or Schedule B.

[40] TAS recognizes that some exempt organizations may file a Form 990 even if they are not required to do so. These organizations likely file "optional" Forms 990 because (1) their donors want the additional information shown on Form 990 to be disclosed publicly, or (2) the organization keeps records of all Form 990 information and they want to provide the IRS with this information. TAS believes that greater information disclosure is beneficial to donors and potential donors, and that additional information can be provided in conjunction with simplified IRS information reporting

[41] Memorandum for Director, Exempt Organization SE:T:EO, *EO Correspondence Review and Timeframes* (October 2003). The IRS Ogden Campus, which is the centralized site for processing 990 information returns, conducted a study and made specific recommendations on how to reduce DDPs that are later abated. The TE/GE Customer Accounts Service analyst staff conducted a review of correspondence data from several return processing functions at the Ogden campus as it pertains to accuracy and timeliness. In addition, the review collected information from the document perfection (code and edit) operation. They gathered data to determine (1) how often IRS receives a reply within the given timeframe, and (2) what items are involved with the TE/GE correspondence program. IRM § 21.7.7-4 provides a listing of Information Return Items (IRI).

missing Schedules A and B were responsible for most assessed DDPs.[42] Based on these findings, Ogden analysts recommended that the IRS redefine what constitutes an IRI and increase its timeframes for the exempt organization to reply.[43] If implemented, these recommendations would allow the IRS to be more flexible in applying the DDP, to secure the missing information by phone or correspondence before assessing a penalty, and even eliminate the penalty in some situations.[44] These recommendations were made in October 2003. To date the IRS has not implemented them. While the study identifies the types of non-compliance, it does not identify the reasons why exempt organizations are making mistakes.

Modernization Efforts - Electronic Filing

Although electronic filing has been available to individual taxpayers since 1986, it was not until tax year 2004 that the IRS updated its systems to allow Form 990 to be filed electronically ("e-filing").[45] In addition, the IRS does not provide free filing software or Internet links for exempt organizations to electronically file Form 990. It is not surprising that individuals filed 66 million out of 120 million returns electronically for tax year 2004, whereas 863 of 796,000 exempt organizations e-filed information returns.[46] As of October 2, 2005, the IRS had received 4,725 exempt organization returns electronically for this year.[47] The IRS wants and needs the information that is provided on exempt organization returns in order to be effective in their oversight. Therefore, e-filing should be simple, free, and accessible.

TE/GE Communication

Access to the IRS

When taxpayers become confused or have questions about an exempt organization's federal tax filing obligations, they may attempt to call the IRS. TE/GE currently answers only about 60 percent of the calls that come in on its toll-free help line. In FY

42 Ogden Form 990 Study, Attachment to Memorandum for Director, Exempt Organization SE:T:EO, *EO Correspondence Review and Timeframes* (October 2003). Sample Size Form 990, 112, Form 990 EZ 206. Error type: Missing Schedule B, Form 990, 70 percent, Form 990EZ, 41 percent; Missing Schedule A, Form 990, 13 percent, Form 990 EZ,13 percent.

43 Memorandum for Director, Exempt Organization SE:T:EO, *EO Correspondence Review and Timeframes* (October 2003).

44 *Id.*

45 Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, June 2005, 5; 2005 TNT 81-7, Tax Analysts, Tax Notes Today, APRIL 28, 2005, *IRS Reports Figures For E-Filing Of EO Returns.* (Section 501 – Tax-Exempt Organizations) (Release Date: April 27, 2005) (Doc 2005-8872).

46 IRS News Release, 2005, *Tax Filing Season Sets Records*, IR-2005-53, April 28, 2005; 2005 TNT 81-7, Tax Analysts, Tax Notes Today, April 28, 2005, *IRS Reports Figures For E-Filing Of EO Returns. (Section 501 – Tax-Exempt Organizations)* (Release Date: April 27, 2005) (Doc 2005-8872); *IRS Data Book 2004*, Table 2, Summary of Number of Returns Filed, by Type of Return, Fiscal Years 2003 and 2004.

47 EO Update, 2005-14 (October 7, 2005). E-filed forms were: 408 Forms 990; 257 Forms 990-EZ; 22 Forms 990-PF; one Form 1120-POL; and 172 electronic filings of Form 8868, *Application for Extension of Time to File an Exempt Organization Return. Id.*

2005, the help line answered 452,569 of the 756,888 calls it received, a service level rate of 59.8 percent.[48]

If the IRS does answer the phone, only customers who speak English receive service. The phone recording does offer a Spanish option, but callers who select this option are told to call back with an interpreter and then receive a "courtesy disconnect."[49] Table 1.17.5 shows the TE/GE phone line's call volume and response rates for fiscal years 2002 through 2005.

TABLE 1.17.5, TE/GE TOLL FREE CALL VOLUME AND ACCESS RATES FOR FY 2002 THROUGH FY 2005[50]

Fiscal Year	2002	2003	2004	2005
Calls Attempted*	507,872	680,371	850,097	756,888
Calls Answered	433,823	446,410	506,572	452,569
Percentage**	85.4%	65.6%	59.6%	59.8%
Average Speed of Answer[51]	Not available	169 seconds	256 seconds	278 seconds

The IRS recognizes that TE/GE phone response is a continuing problem, but so far has done little to provide a remedy. In its FY 2006 Strategic Assessment Report (SAR), TE/GE lists call demand exceeding toll-free capacity as its top "trend, issue or problem" (TIP). The FY 2006 SAR points out that TE/GE toll-free service shortfall has been a problem since the phone line's inception. Customer demand for the toll-free site increased 243 percent from the site's inception in 1999 to the end of FY 2003 – an annualized rate of 36 percent.[52] Call demand was so great that in FY 2003, TE/GE answered 12,500 more toll-free calls than it had in the previous year, but the percentage of calls answered fell from around 85 percent in FY 2002 to approximately 60 percent in FY 2005. TE/GE is concerned that without additional resources to handle the rapidly increasing call demand, its toll-free service will continue to deteriorate significantly. TE/GE also believes that the success of other TE/GE customer services initiatives, such

48 TE/GE *FY 2006 Strategic Assessment; TE/GE Cincinnati Call Center, Call Data Summary – FY 2002, 2003, 2004, & 2005.*

49 Telephone Data Report, *TE/GE Toll Free Customer Service FY 04*, 1-877-829-5500 (October 5, 2004). In FY 2004, 2,518 callers attempted to access the Spanish "option." Of these, 2,260 received the courtesy disconnect and 258 elected to continue their call in English.

50 Telephone Data Report, *TE/GE Toll Free Customer Service* - Cincinnati – FY 03, 04, Weeks Ending 10/4/2003, 9/25/2004TE/GE Cincinnati Call Center, Call Data Summary FY 2005; *Calls Attempted (Calls Attempted During Business Hours less Primary Abandoned Calls). Primary Abandoned Calls include calls that are abandoned before the caller makes a menu selection, and calls that are received when the toll-free site is closed for either an emergency (such as a weather related closure) or a business related reason (such as site wide training). In 2004, there were 84,890 primary abandoned calls. ** Formula: (Net Calls Answered)/Calls Attempted.

51 Average time customers wait in the queue before receiving service.

52 TE/GE, *Strategic Assessment* (FY 2006) at 2. Note: TE/GE assessment reports access rates do not include primary abandoned calls.

as Form 990 e-file, will depend on access to toll-free assistance.[53] TE/GE recognizes that poor toll-free assistance will ultimately affect compliance:

> With few other service options currently available to TE/GE customers, preventing a significant deterioration in toll-free service is critical to TE/GE's mission success. In addition to frustrating customers and employees, a low level of service can lead to other more serious and costly problems such as inaccurate filings. Good toll-free customer service is especially important for ensuring voluntary compliance among TE/GE customers since the Division has very limited resources for more traditional compliance activities like examination."[54]

TAS agrees with TE/GE's assessment. We also believe, however, that the time has come for the IRS to stop writing about the problem in strategic assessments and to actually provide the resources needed to adequately staff the TE/GE phone line.

Outreach and Education

The IRS could avoid many of the problems discussed above if exempt organizations better understood their federal tax filing and reporting obligations. Improved outreach and education to exempt organizations could help prevent the common errors that result in assessed penalties – particularly those penalties for unintentional errors or minor infractions that are later abated. Outreach and education efforts at the front end of the process would also reduce the resources needed at the back end to correct problems. The IRS has chosen, however, to expend nearly all available TE/GE resources on enforcement. TE/GE's Communication, Education and Outreach division's (CE&O) staff currently stands at six.[55]

These six employees are largely responsible for all exempt organization outreach and education programs. These programs include day long workshops offered to charitable organizations and shorter workshops offered through the IRS sponsored Nationwide Tax Forums.

Outreach Materials

Over the last few years, TE/GE has developed comprehensive outreach and education materials and some helpful programs. In addition to the publications already in print, TE/GE completed the plain-language publications initiated in FY 2004, and is working on a limited number of new items in FY 2005:

- Revision of Publication 578, *Tax Information for Private Foundations and Foundation Managers*;

[53] TE/GE, *Strategic Assessment* 3 (FY 2005).

[54] *Id.* at 10.

[55] *Id.*

- Revision of Publication 3079, *Gaming Publication for Tax-Exempt Organizations*; and
- Revision of Publication 892, *EO Appeal Procedures for Unagreed Issues*.[56]

Table 1.17.6 lists CE&O's publications and the quantities produced.

TABLE 1.17.6, CE&O PUBLICATIONS DEVELOPED FOR EXEMPT ORGANIZATION EDUCATION AND OUTREACH INCLUDING QUANTITIES PUBLISHED.[57]

Title	Publication Number	Date of original publication	Total quantity printed to date
Charitable Contributions: Substantiation and Disclosure	1771	April 2002	72,700
Disaster Relief, Provide Assistance Through Charitable Organizations	3833	July 2002 (available earlier on web)	22,500
Tax Guide for Churches and Religious Organizations	1828	September 2003	75,500
Tax Guide for Churches and Religious Organizations (Spanish)	1828	September 2003	8,000
Applying for 501(c)(3) Tax Exempt Status	4220	September 2003	80,000
Compliance Guide for 501(c)(3) Tax Exempt Organizations	4221	September 2003	115,000
A Charities Guide to Car Donations	4302	August 2004	20,000
A Donor's Guide to Car Donations	4303	August 2004	20,000
EO Bookmark	4049	July 2002	57,400
EO Brochure	3637	July 2002	42,400

Although TE/GE has developed a number of helpful publications, distribution of the information is limited by TE/GE's publishing budget. The quantities published to date indicate that the IRS is not printing educational materials commensurate with the size of the exempt organization sector. Moreover, TE/GE does not currently track the delivery method for these publications. Hence, there is no good indicator of demand or audience for the various publications.

Charitable Organization Workshops

TE/GE offers one-day workshops to the general public, which cover federal tax and filing issues for exempt organizations. Participants are charged $30 to attend, with the fee covering expenses such as conference room rental, course material printing, and IRS instructor travel costs. Workshop attendees learn about tax-exempt status issues (including actions that may jeopardize tax-exempt status), unrelated business income, gaming activities, employment issues, recordkeeping, preparing and filing Form 990, exempt organization audits, and required disclosures. Participants also receive an 11 chapter booklet containing explanations, a glossary, and numerous examples based on actual TE/GE audit cases. Currently, this booklet is available only to workshop attendees. The workshop does not cover the tax-exempt application process. In FY 2005, TE/GE offered this workshop 18 times in six cities (Houston, New York, San Francisco,

[56] IRS News Release 2005-05-24 (November 4, 2004); http://www.irs.gov/pub/irs-TE/GE/implementing_guidelines_1104.pdf 25.

[57] TE/GE Director of Exempt Organization Customer, Education and Outreach, (October 11, 2005).

Cleveland, Washington, D.C., and Charlotte, N.C.)[58] Workshop capacity is generally 150 people, and 13 of the 18 events sold out. In addition to sending notification to exempt organizations in the cities where the workshops are held, information about these workshops is publicized in Tax Notes Today and articles are e-mailed to subscribers to the IRS EO Update electronic newsletter.[59]

Because the workshop was offered only 18 times in FY 2005, a maximum of 2,700 people had the opportunity to attend.[60] There are currently over one million exempt organizations, and in 2004 over 796,000 exempt organizations filed information returns.[61] Furthermore, from FY 2001 to FY 2004 the number of new exempt organizations filing Forms 990 has increased at an average rate of about 27,000 per year and the total number of new exempt organizations each year has increased an average of over 37,000 for the last four years.[62] Thus, only a miniscule fraction of exempt organizations received the valuable information provided at the seminar. Additionally, because TE/GE only offered the workshop in only six major cities, most organizations outside those cities and surrounding areas did not have the opportunity to send an attendee.

The exempt organization workshops provide valuable information to charitable exempt organizations and arm attendees with the knowledge necessary to avoid many filing and compliance errors that can lead to penalties. This information, however, needs to go to a much wider audience. We recognize that TE/GE's outreach resources are limited. Nevertheless, we believe that if the IRS analyzed the cost of the downstream consequences of inadequate education among exempt organizations, the workshops would emerge as a highly cost effective measure. The IRS should investigate cost effective ways to expand the workshops' coverage – such as offering the workshop in more cities, developing a "virtual workshop" for the IRS website or closed circuit television, providing a series of two-hour "mini workshops" by teleconference and offering the workshop materials to organizations that cannot send attendees. Moreover, TE/GE should consider partnering with nonprofit umbrella organizations, such as community foundations or schools of public administration, to co-sponsor workshops.

58 Tax Notes, *Offering EO Workshops* (January 13, 2005).

59 *Id. See also* IRS, *EO Update, Issue 2005-03* (February 15, 2005), at http://www.irs.gov/charities/article/0,,id=135296,00.html.

60 In at least one city, workshop attendance exceeded capacity. Thus, slightly more than 2,700 people may have attended the workshop in 2005.

61 IRS Data Book 2004, Table 22 – *Tax Exempt Organizations and Other Entity Listed on the Exempt Organization Business Master file, by Type of Organization and Internal Revenue Code Section, Fiscal Year 2001-2004*; IRS Data Book 2004 Table 2 – *Summary of Number of Returns Filed, by Type of Return, Fiscal Years 2003 and 2004.*

62 IRS Data Book 2004 Table 2 – *Summary of Number of Returns Filed, by Type of Return, Fiscal Years 2003 and 2004*; IRS Data Book 2002 Table 2 – *Summary of Number of Returns Filed, by Type of Return, Fiscal Years 2001 and 2002*; Internal Revenue Service Data Book 2004, Table 22 – *Tax-Exempt Organizations and Other Entities Listed on the Exempt Organization Business Master File, by Type of Organization and Internal Revenue Code Section, Fiscal Years 2001-2004.* (Computation: 2004 total 1,680,061 minus 2001 total 1,567,580 divided by 3). Note: Entities with gross receipts less than $25,000 and churches are generally not required to file Form 990.

Tax Forums

TE/GE currently offers courses at the IRS sponsored Nationwide Tax Forums. The Tax Forums are the IRS' primary outreach program for tax practitioners and professionals.[63]

Table 1.17.7 summarizes the TE/GE courses offered at the Tax Forums over the last two years.

TABLE 1.17.7, IRS NATIONWIDE TAX FORUMS – EXEMPT ORGANIZATIONS PARTICIPATION[64]

2004 Presentations	Course Time	Attendance
Seminar: Form 990 Tips and Tools	50 min	3,890
Seminar: Do's and Don'ts for Churches and Other Section 501(c)(3) Organizations	50 min	4,320
Workshop: Applying for Tax Exempt Status	3 hours	1,322
2005 Presentations		
Seminar: The New Form 1023	50 min	3,800
Seminar: Political and Legislative Activity by Section 501(c)(3) Organizations	50 min	3,300
Workshop: Form 990 Information Return	2 hours	1,847

The workshops were instantly popular and completely oversubscribed. TE/GE had initially planned to present one workshop for 75 people at each forum, but to meet demand, the division ended up presenting two or three workshops – with 125 attendees at each session – at each of the six Tax Forums. Even then, some would-be attendees were left "standing in the hall."[65]

TAS commends TE/GE for its Tax Forum presentations and workshops. We note, however, that the Tax Forums are outreach for tax professionals and practitioners, so many small organizations that cannot afford to hire these professionals do not receive the information. The IRS should be aware of these smaller exempt organizations and find ways to ensure that they receive the information necessary to avoid common filing errors and other compliance difficulties.

Partnering with the Exempt Organization Community and Nonprofit Sector

One way the IRS could improve its outreach to small exempt organizations is by working with organizations that currently provide training and guidance to the exempt organization community and nonprofit sector. These organizations are located throughout the country (and on the internet) and sponsored by various groups including Low Income Taxpayer Clinics, schools of public and business administration, private foundations, and for-profit entities. These organizations provide numerous services to assist exempt organizations with various issues (both tax and non-tax related) and provide

[63] IRS, *IRS Nationwide Tax Forums*, at http://www.irs.gov/taxpros/article/0,,id=97192,00.html.

[64] TE/GE Director of Exempt Organization Customer, Education and Outreach (October 11, 2005).

[65] Steven T. Miller, Commissioner TE/GE Speech to IRS Tax Forums, Houston, Texas (July 12, 2005).

start-up and operational support. Some of these organizations also provide training for exempt organization workers and volunteers for a nominal fee or for no cost.[66]

The IRS could significantly increase its outreach to exempt organizations by partnering with these organizations to distribute material and provide information about accurate information reporting and tax compliance.

Web Based Outreach

In FY 2004, TE/GE CE&O maintained and developed the "charities and non-profits" portions of the IRS website (www.irs.gov). Working with the Advisory Committee for TE/GE and TE/GE's Communications and Liaison office, CE&O successfully launched the "Life Cycle of a Public Charity" web pages. In FY 2005, CE&O will launch the "Life Cycle of a Private Foundation" and continue to add material to both Lifecycle pages to develop their usefulness for EO customers. CE&O will continue to maintain all the EO pages on the Internet.[67]

CONCLUSION

TAS recognizes and supports the three distinct roles the IRS plays for exempt organizations. The compliance-related roles of overseer and regulator are essential to TE/GE's mission to "protect the public interest" by ensuring that exempt organizations are not abusing their tax exempt status. This is particularly true in light of recent exempt organization involvement in abusive tax shelter activity.

However, TAS strongly believes that the IRS's two compliance roles cannot overshadow its customer service role of educator and advisor to exempt organizations. When this happens, the IRS fails in its mission to "provide … top-quality service" to exempt organizations "by helping them understand and comply with applicable tax laws." Furthermore, it serves neither the IRS nor the exempt organization community (not to mention the populations these organizations serve) when exempt organizations are hindered by tax reporting problems that could be avoided with additional IRS outreach and customer service.

IRS COMMENTS

The National Taxpayer Advocate's report discusses the daily delinquency penalties that the IRS imposes when an exempt organization files an information return late, or when it files a report with missing or incomplete information. The penalty is imposed pursuant to IRC § 6652(c)(1)(A) and is intended to encourage the timely and complete filing

[66] Some of these organizations include the Community Tax Law Project in Richmond, Virginia (www.ctlp.org); Virginia Commonwealth University's Nonprofit Enterprise Institute (www.vcu.edu/nonprofit) and Office of Community Programs (www.vcu.edu/ocp/programs/nonprofitorgs/index.html); the TechSoup website (www.techsoup.org); the Independent Sector (www.independentsector.org); and the University of San Francisco's Institute for Nonprofit Organization Management (www.inom.org).

[67] http://www.irs.gov/pub/irs-TE/GE/implementing_guidelines_1104.pdf 27.

of information returns. In appropriate cases, when the exempt organization shows that its failure to file was due to reasonable cause, the IRS abates the penalty.

Tax exemption is granted by Congress as a matter of legislative grace. This privilege is granted in recognition of the socially valuable work that tax-exempt organizations perform. In return, tax exempt organizations are required to file information returns, which are available to the media and the public. These returns help assure that the organizations that file them are honoring their bargain with the public. The returns help the IRS monitor tax-exempt organizations' compliance with the tax code, and help assure the public that their contributions and the privilege of tax exemption are being used wisely.

The IRS appreciates the National Taxpayer Advocate's recognition that "the IRS has a legitimate need for timely and accurate information from exempt organizations," and that "it is appropriate for the IRS to assess penalties on exempt organizations that do not comply with the requirements for tax exempt status." The IRS has found that the daily delinquency penalties can be an effective tool in spurring exempt organizations, both large and small, to satisfy their reporting obligations.

The daily delinquency penalties also play a useful educational role. The penalties give the IRS a means, short of the extreme measure of revocation of tax-exempt status, to draw an exempt organization's attention to the particulars of its filing obligations. In assessing these penalties, the goal is not to raise revenue, but to obtain information about the tax exempt organization for the IRS and the public, and to secure future compliance. An organization that receives a penalty notice receives, as well, information about the cause of the penalty and the standards for abatement. Often organizations contact the IRS concerning these notices. In those cases, we are able to answer questions about the filing obligations, increase the probability of compliance for future years, and, in cases where the reasonable cause standard is met, abate the penalty.

The IRS believes that the problem of the assessment and abatement of daily delinquency penalties is not as acute as a quick reading of the National Taxpayer Advocate's report would suggest. In the opening paragraph of this portion of the report, which defines the problem, the National Taxpayer Advocate has aggregated data covering a 12 year period and has stated that 525,322 penalties, totaling more than $1.7 billion, were abated after being assessed. While these figures are generally correct, the scale of the problem would seem to be more accurately portrayed when viewed, as such things usually are, on a yearly basis. For the twelve years in question, an average 43,780 penalties were abated each year. For each of the past three years, an average 44,354 penalties were abated. By contrast, more than 650,000 information returns were filed by exempt organizations over each of the past three years. Viewed this way, penalties were assessed and later abated with respect to less than seven percent of filed returns.

Obviously, the IRS would like to see the number of assessed penalties reduced even lower. That would reflect an improved level of compliance, which, of course, is our goal.

To that end, the IRS has made, and continues to make, a strenuous effort to inform exempt organizations of their filing obligations, and help them comply through a variety of means, many of which are noted in the National Taxpayer Advocate's report.

One of the IRS's primary tools to inform and assist exempt organizations is the Tax Exempt and Government Entities toll-free call site, located in Cincinnati. This service is widely used by the public, and demand for it has increased significantly every year since it was initiated. However, as the National Taxpayer Advocate notes, budget constraints have meant that funding for this service has not kept pace with demand, and the level of service the IRS has been able to provide has declined, especially in the last two years. The level of service for all of 2005 was 59.8 percent. The IRS has been at work on this problem, however, and in recent months the level of service has turned upward and climbed to an annual rate of 68 percent (November cumulative). Moreover, a level of service of 68 percent does not mean that 32 percent of callers went without service. It means that 32 percent of calls did not get through on the first attempt. Most callers, however, make additional attempts, and do have their questions answered.

The Exempt Organization's Customer Education and Outreach function has also focused on educating exempt organizations about their filing obligations. One of the ways it does this is through the IRS website where filing tips and the most common filing errors are posted. Another way is through the preparation and dissemination of specialized publications. The National Taxpayer Advocate lists these publications, notes the number of copies of each published to date, and then curiously concludes that the IRS is not "printing educational materials commensurate with the size of the exempt organizations sector." As our stakeholders have told us, the world communicates with its customers via the internet these days, and so does the IRS. Each of these publications is available on the web. Each can be instantly accessed by exempt organizations in any location and downloaded. In the past year, we recorded 239,641 views and 116,956 visits to our site where these publications are posted. Under these circumstances, the IRS believes it would be wasteful, and contrary to good customer service, to spend the money to produce and effectively distribute larger numbers of paper publications.

Moreover, filing errors by exempt organizations, and related penalties, should be reduced as electronic filing of exempt organization returns, which the IRS introduced in 2004, takes hold. That a relatively small number of organizations used e-filing in 2004, its first year, is neither surprising nor a cause for concern. The program will grow. Indeed, as of December 6, Exempt Organizations had reached 99 percent of its calendar year 2005 goal for accepted returns and extensions. To spur this process, the IRS expanded its' marketing of electronic filing for exempt organizations, published articles about e-filings in the SSA/IRS Reporter, held e-file telephone forums, sent out mailings, and expanded the number of Frequently Asked Questions devoted to this subject on our website. Although the IRS does not have, and therefore cannot provide, electronic filing software free to the public, such software is available from the Urban Institute. Information concerning this is posted at irs.gov.

The National Taxpayer Advocate favorably mentions the IRS workshops and suggests it investigate cost effective ways of expanding their coverage. The IRS has been at work on this very issue. In 2005, the IRS experimented with using telephone forums as a means of providing information to the exempt organizations community on the revised Form 1023, the application for tax-exempt status. Participant response was overwhelmingly positive, and we will expand our use of this technique. This will allow the IRS to reach more organizations.

The IRS will continue, as well, to provide live workshops for small and mid-sized exempt organizations in cities throughout the country. Since 2002, when the program was initiated, the IRS has conducted workshop in 26 cities, in all parts of the country. More than 7,000 registrants have attended. The workshops are designed to help representatives of these organizations understand their basic tax compliance responsibilities. The IRS will also develop web-based training modules of key parts of this workshop. This will allow us to educate a greater number of individuals in a way that is cost-effective both to them and to the IRS.

The IRS appreciates the National Taxpayer Advocate's interest in exempt organizations and in the unique opportunities and challenges the IRS faces in serving this important group of customers.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate generally commends the IRS TE/GE Division's efforts to serve and assist exempt organizations and the nonprofit sector. We also appreciate that TE/GE has limited resources to continually perform a difficult balancing act in both serving these organizations and working to ensure that they are not abusing their tax exempt status. Our intent with this Most Serious Problem is to highlight TE/GE's need for additional resources to be dedicated outreach and education to the exempt organization sector.

Penalties

The National Taxpayer Advocate generally agrees with the IRS's views that the Daily Delinquency Penalty (DDP) imposed by IRC § 6652(c)(1)(A) is intended to encourage the timely and complete filing of information returns and that imposing this penalty in appropriate cases can help assure that exempt organizations are honoring their bargain with the public to provide socially valuable services in exchange for exemption from federal tax. The IRS response, however, does not recognize that the high DDP abatement rate is a problem. We appreciate the IRS view that over the past three years, assessed DDPs were abated with respect to less than seven percent of filed exempt organization information returns. However, the fact remains that during these same three years, the IRS abated, on average, nearly 60 percent of all assessed DDPs and over 64 percent of all assessed DDP dollars.[68]

[68] *See* Table 1.17.3 *supra*.

The IRS response indicates that the current DDP abatement rate is acceptable in light of the "useful educational role" these penalties play for exempt organizations. The National Taxpayer Advocate does not agree with the IRS imposing penalties as a way to "educate" taxpayers. Penalties can place significant burdens on both taxpayers and the IRS. This is particularly true for small exempt organizations that rely on volunteer staff for information reporting compliance. When the IRS imposes a penalty on a small exempt organization to "teach" correct information reporting standards, the organization finds itself strapped with the administrative burden of getting the penalty abated. Organizations with volunteer staffs may fail to grasp the "lesson" the IRS is teaching when it sends the organization a penalty notice. And volunteer staffs with little IRS experience may not know how to go about requesting a penalty abatement after receiving such a notice. Thus, the lessons learned from these "educational" penalties could be prohibitively expensive for small exempt organizations.

Assessing "educational" penalties also unduly burdens the IRS. IRS resources are expended when penalties are assessed and later abated. Assessing penalties that the IRS expects to later abate once the penalized taxpayer "learns its lesson" makes little sense. The valuable resources used in this "educational" assessment/abatement exercise, could be much better utilized in actual outreach and education programs that would help exempt organizations avoid filing mistakes and penalties altogether.

Toll-Free Call Site

The IRS asserts that penalized organizations often contact the IRS concerning penalty notices and that, in those cases, the IRS can answer questions about filing obligations and increase the probability of compliance in future years. The National Taxpayer Advocate questions this assertion in light of the TE/GE toll-free call site's service numbers. Exempt organizations calling this site for help have a 30-40 percent chance that their call will not be answered. These callers are, of course, free to try and call again (and the IRS asserts that "most callers" do), but being forced to make numerous calls to the TE/GE toll-free call site for assistance is an unfair burden on exempt organizations – particularly those that are attempting to deal with IRS notices and penalties. The National Taxpayer Advocate believes that the IRS should make improved TE/GE call site service a top priority.

Outreach and Education

We commend the IRS for the quality of its existing outreach materials – particularly the live workshops offered to small and mid-sized exempt organizations. The IRS should continue to offer these live workshops to as many exempt organizations as possible. We are encouraged by IRS efforts to expand the scope of this workshop through the telephone and internet to those organizations that cannot send a representative to attend a workshop in person.

The quality of published information provided to exempt organizations is generally good (although more could be done to clarify the Schedules A and B filing requirements for Form 990 and 990-EZ filers), and we commend the IRS for making this information available through the IRS website. However, the IRS can do more to develop target audiences for this information and be more proactive in distributing hard copies of this information directly to target audiences rather than merely waiting for exempt organizations to download the information from the IRS website. One measure that would help the IRS achieve a more targeted distribution, would be actively partnering with non-IRS organizations that serve the exempt organization community. These organizations already have existing ties to the exempt organization community and could assist the IRS with distributing information to exempt organizations, as well as help educate the IRS concerning what information exempt organizations most need to comply with their filing and reporting obligations.

TAS is willing to assist TEGE in any way to develop new brochures and distribute this information to the Exempt Organization stakeholder community. We note, however, that TAS assistance is not a replacement for increased and adequate funding of TEGE's EO outreach function.

RECOMMENDATIONS

- Revise the Form 990 and Form 990-EZ instructions to improve clarity and ease of use. These instructions should particularly be revised to clearly set forth the Schedules A and B filing requirements. Alternatively, revise Forms 990 and 990-EZ themselves to include Schedules A and B as part of the forms.
- Implement the recommendations made by the TE/GE Customer Account Services 2003 Ogden Campus Study (Ogden Study):
  - Redefine what constitutes an Information Return Item (IRI) error.
  - Increase the time allowed for exempt organizations to reply to filing error notices before being penalized.
- Contact the exempt organizations sampled for the Ogden Study to identify (1) why these organizations made filing errors and (2) what information would have helped them avoid these errors. Use this information to develop an education and outreach strategy to reduce common Form 990 and 990-EZ filing errors.[69]
- Provide the necessary resources to adequately staff the TE/GE toll-free phone line.
- Develop partnerships with existing organizations that serve and educate the exempt organization community. These partnerships could help the IRS (1) target and deliver need specific information to exempt organizations; (2) reach more exempt organizations with existing materials, information, and workshops; (3) co-sponsor additional workshops for exempt organizations; and (4) receive feedback from the

[69] If Ogden Study sample data is no longer available, the National Taxpayer Advocate recommends conducting a new study with new sample organizations.

exempt organization community on how the IRS could best help exempt organizations correctly comply with information reporting obligations.

- Develop a publication specifically for trustees and directors of exempt organizations such as, "What you need to know about your exempt organization's tax obligations."
- Develop a tax reporting handbook specifically for small exempt organizations. Alternatively, make the course materials for the small and mid-sized exempt organization workshop available to non-attendees.

PROBLEM

TOPIC #18 MOST SERIOUS PROBLEM: DIRECT DEPOSIT OF INCOME TAX REFUNDS

RESPONSIBLE OFFICIAL

Richard J. Morgante, Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

The IRS promotes direct deposit as a way for taxpayers to receive their tax refunds quickly and safely. Despite the benefits of direct deposit, the problems associated with a misdirected direct deposit refund[1] are more difficult to remedy than those involving a misdirected paper refund.

Tax return instructions caution that the IRS is not responsible for a lost refund if a taxpayer enters the wrong account information on his or her tax return.[2] Despite this warning, many taxpayers do make mistakes, which make it difficult or sometimes impossible for them to receive their refunds. Moreover, tax return preparers, financial institutions,[3] and even the IRS can make inadvertent errors in processing refund returns.

Currently, there are no procedures in place for the IRS, the Financial Management Service (FMS), and financial institutions to address inadvertent errors by taxpayers relating to direct deposits of tax refund checks. There are also no provisions allowing the IRS to take money out of an incorrect account or receive confidential information about the owner of that account from the financial institution. This situation leaves the IRS with access only to the information the account owner voluntarily provides to the IRS. Thus, any dispute over the accuracy of a direct deposit refund must be resolved between the taxpayer and the financial institution itself, with little assistance from the IRS. While financial institutions can correct their mistakes, they do not always take corrective action when the taxpayer made the mistake. Without any process in place for handling these cases, there is no remedy for the taxpayer.

ANALYSIS OF PROBLEM

History

Beginning in tax year (TY) 1987, the IRS offered taxpayers who filed returns electronically the option of having their refunds deposited directly into their savings or checking account.[4] In TY 1996, the IRS extended this option to taxpayers who filed

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[1] Throughout this discussion, the term "misdirected refund" refers to a tax refund that was deposited into the incorrect bank account.

[2] IRS Instruction 1040, *Instructions for Form 1040, U.S. Individual Tax Return* 54 (2004). This discussion will focus on mistakes made in direct depositing of refunds and will not discuss fraud relating to direct deposit.

[3] Throughout this discussion, the term "financial institution" refers to banks and other institutions that receive tax refunds from the Treasury Department and deposit the funds into individuals' accounts.

[4] IRS Form 8453, *U.S. Individual Income Tax Declaration for Electronic Filing (*1987) (first year IRS provided for direct deposit of tax refund for taxpayers who file electronically).

paper returns.[5] Table 1.18.1 shows that the number of taxpayers using this service has increased in each of the last seven years.

TABLE 1.18.1, INCREASING USE OF DIRECT DEPOSIT

Tax Year	Tax returns processed[6]	Tax refunds certified[7]	Direct deposit refunds issued	% of refunds certified that are direct deposit	Total direct deposit refunds in billions
1998[8]	107,338,000	78,991,000	19,030,000	24.1%	$34.063
1999[9]	108,927,000	85,307,000	23,232,000	27.2%	$46.761
2000[10]	112,825,000	86,842,000	28,905,000	33.3%	$59.750
2001[11]	115,549,000	88,019,000	33,334,000	37.9%	$70.727
2002[12]	120,514,000	94,159,000	39,146,000	41.6%	$91.444
2003[13]	120,261,000	94,442,000	43,630,000	46.2%	$102.380
2004[14]	120,957,000	96,406,000	48,348,000	50.2%	$117.431
2005[15]	121,775,000	95,017,000	51,610,000	54.3%	$130.041

The IRS initially set very stringent requirements to obtain a direct deposit. Tax returns included an "ownership of account" section in which a taxpayer was required to indicate whether the account information provided was for his or her own account, a spouse's account, or a joint account.[16] The ownership of account information allowed the IRS to reject direct deposits for those taxpayers whose bank account information did not match the tax return information.

In TY 1996, a significant change occurred in electronic filing when the IRS dropped its requirement of identifying account ownership.[17] The IRS no longer required financial

5 IRS, *IRS Expands Direct Deposit for Refunds*, News Release 95-68 (Nov. 30, 1995).

6 The number of tax returns processed by the IRS is distinguished from the number of tax returns received by the IRS through the same date. Not all returns received were processed as of the date these numbers were recorded.

7 The number of tax refunds certified accounts for only those tax returns the IRS has processed and does not account for any tax returns the IRS has received but is waiting to process.

8 IRS, *Weekly Filing Statistics* (as of June 12, 1998).

9 IRS, *Weekly Filing Statistics* (as of June 11, 1999).

10 IRS, *Weekly Filing Statistics* (as of June 09, 2000).

11 IRS, *Weekly Filing Statistics* (as of June 15, 2001).

12 IRS, *Weekly Filing Statistics* (as of June 14, 2002).

13 IRS, *Weekly Filing Statistics* (as of June 13, 2003).

14 IRS, *Weekly Filing Statistics* (as of June 11, 2004).

15 IRS, *Weekly Filing Statistics* (as of June 10, 2005).

16 IRS Form 8453, *U.S. Individual Income Tax Declaration for Electronic Filing* (1987) (line 9 requires taxpayer to indicate owner of depositor account).

17 IRS Form 8453, *U.S. Individual Income Tax Declaration for Electronic Filing* (1996) (owner of depositor account no longer required); *compare* IRS Form 8453, *U.S. Individual Income Tax Declaration for Electronic Filing* (1995) (line 10 required taxpayer to indicate owner of depositor account).

institutions to ensure that the taxpayer's name matched the name on the account into which the refund was deposited. From this point on, as long as the account number was a valid account number, the bank deposited the funds even if the account did not belong to the taxpayer. While the change in procedure eliminated some of the difficulties previously associated with direct deposit, it also ended the IRS's check on the accuracy of account ownership information.

Currently, to obtain a tax refund via direct deposit, the taxpayer is simply required to provide an account's routing transit number (RTN), deposit account number, and type (checking or savings) on his or her tax return.[18] This information is necessary for the IRS to identify the specific account in which to deposit the refund. The correct processing of the direct deposit of a tax refund is dependent upon the taxpayer providing an accurate bank account and routing number. In some instances, the taxpayer makes a mistake in the information, and his or her refund is misdirected and deposited into the account of someone other than the intended taxpayer.[19]

In calendar year 2004, 15,550 direct deposit returns entered the IRS's refund trace procedures to resolve a potential problem with the refund.[20] Of those refunds that entered the trace procedures, almost 10 percent were the result of some type of error on the part of the taxpayer.[21] Although the problem is limited in scope – these refunds accounted for only .032 percent of the almost 50 million deposit returns in 2004 – its impact on affected taxpayers is great.[22]

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[18] IRM § 3.17.79.3.8 (Apr. 1, 2004); *see also*, IRS Form 1040, *U.S. Individual Income Tax Return* (2004); IRS Form 1040EZ, *Income Tax Return for Single Filers and Joint Filers with No Dependents* (2004).

[19] A person holding a Power of Attorney (POA) or paid preparer can make similar mistakes. These situations share many of the same issues that arise in the context of taxpayer mistakes.

[20] Direct Deposit Task Force, *Direct Deposit Study*, 5 (June 2005). A refund trace is the IRS procedure for tracking a stolen, lost, or misplaced tax refund check and replacing the taxpayer's authorized refund. IRM § 21.4.2.2 (Oct. 1, 2002). The IRM lays out the process for a refund trace. IRM § 21.4.2.3 (Oct. 1, 2002). Once the taxpayer contacts the IRS and states his/her refund was lost, stolen, destroyed or never received the IRS enters an indicator on the taxpayer's account. This indicator initiates an inquiry to FMS and FMS replaces the original check or sends the taxpayer a photocopy of the cashed check and a claim form.

[21] Direct Deposit Task Force, *Direct Deposit Study*, 5 (June 2005). The other results of the refund trace procedures were caused by an IRS error (0.44 percent) and bank error (1.07 percent). By far, the largest cause of tax refunds entering the refund trace procedure is that the taxpayer forgot that he or she had received a Refund Anticipation Loan (RAL) or a Refund Anticipation Check (RAC) (88.76 percent). Direct Deposit Task Force, *Direct Deposit Study*, 5 (June 2005). For additional information about RALs and RACs, *see* Most Serious Problem, *Refund Anticipation Loans; Oversight Of the Industry, Cross-Collection Techniques and Payment Alternatives, supra.*

[22] The percentage of direct deposit returns entering the refund trace procedure decreased from calendar year 2003 to 2004. In calendar year 2003, 18,960 direct deposit returns entered the IRS' refund trace procedures, accounting for .042 percent of the almost 45 million direct deposit returns in 2003. Information provided by Operating Division.

Misapplied Direct Deposit Refunds

How Direct Deposit Works

As described above, a taxpayer can elect to have his or her refund directly deposited into a checking or savings account at a bank or other financial institution by providing the bank account and routing numbers on the tax return. Once the taxpayer requests a direct deposit, the IRS processes this transaction by delivering an Automated Clearing House (ACH) file to FMS.[23] FMS processes the ACH file and delivers the transaction for distribution throughout the ACH Network. FMS then debits the FMS account for the total amount of the tax refund directly deposited into the taxpayer's account. The financial institution that receives the direct deposit transaction (the taxpayer's bank) credits the taxpayer's account and reports the transaction on the taxpayer's monthly account statement. At this point, the taxpayer has received his or her refund through direct deposit and the transaction is complete.

Types of Mistakes

There are numerous opportunities for mistakes to occur in the direct deposit system. The remedy for mistakes differs according to which party – the IRS, the preparer, the bank, or the taxpayer – caused the error.

EXAMPLE 1 – IRS MISTAKE

Jane Jones prepared her 2003 tax return herself and was entitled to a $2,500 refund from the IRS. On February 15, 2004, Jane filed her return electronically, providing her bank account and routing numbers so she could receive her refund quickly through IRS direct deposit. On March 15, 2004, Jane checked her bank account and realized she had not yet received her refund from the IRS. Jane used the "Where's My Refund?" tool on the IRS website (www.irs.gov) and learned that her refund was deposited in her account on March 1, 2004. Jane checked the printout of her 2003 return and noted that she had accurately listed her bank account and routing numbers. Upon contact, the IRS informs Jane that her refund was mistakenly deposited into a different bank account. [24]

In this instance, a mistake on the part of the IRS caused the misdirected refund. Once Jane notified the IRS of the mistake, the IRS initiated a refund trace.[25] Because an IRS mistake caused the misdirected refund, the IRS issued a manual refund to Jane.[26] The IRS then contacted FMS by telephone and requested assistance in recovering the

[23] The payment of tax refunds by the IRS occurs through the Treasury Department's Financial Management Service (FMS). The Automated Clearinghouse (ACH) is the primary electronic funds transfer (EFT) system through which federal agencies make electronic payments. Financial Management Services, *Overview*, at http://www.fms.treas.gov/ach/index.html (last visited Sept. 26, 2005).

[24] Although this and subsequent examples discuss electronic filing of a tax return, the same mistake could occur if Jane filed her return on paper.

[25] IRM § 21.4.1.4.7.1(4) (Mar. 23, 2004).

[26] IRM § 21.4.1.4.7.4 (Oct. 1, 2003). A manual refund is a refund manually processed by an IRS employee rather than through the IRS's automated process.

funds.[27] Some banks will return the money to the IRS, retrieving it from the incorrect account and notifying the account holder that the money was deposited in error. Other banks will send the account holder an IRS letter stating that his or her account received misdirected funds and request authorization to withdraw the funds and return them to the IRS. If, however, the account was closed, there is no action the bank or the IRS can take against the account holder who received the misdirected funds.[28] In this case, although the taxpayer will receive her refund, the U.S. government does not recoup the refund amount.

EXAMPLE 2 – RETURN PREPARER MISTAKE

Same facts as Example 1, except Jane used a paid preparer who electronically filed Jane's return on February 15, 2004. When Jane checked on irs.gov on March 15, 2004, she learned her refund was deposited on March 1, 2004. Jane contacted her return preparer who realized that he made a mistake in entering Jane's bank account number on the tax return and Jane's refund was deposited in someone else's bank account.

In this case, a mistake by Jane's tax return preparer caused the problem. The ability to recover a refund from the tax preparer will vary, depending on the individual preparer. Some preparers will reimburse the taxpayer. Others may refuse, leaving the taxpayer to complain to the preparer's licensing agency or malpractice insurance carrier (if either is applicable), or to pursue available common law remedies.

EXAMPLE 3 – BANK MISTAKE

Same facts as Example 1, except when Jane learned that her refund was deposited into an account on March 1, 2004, she contacted her bank and discovered it had mistakenly deposited Jane's refund into a different account. In this case, a bank error caused the problem. Upon learning of the mistake, Jane's bank will withdraw the funds from the incorrect account and deposit the money in Jane's account.[29]

As a participant in the ACH and direct deposit system, a financial institution is bound by the rules set forth in 31 C.F.R. § 210. While these regulations establish certain guidelines for the direct deposit system, they offer little protection to a taxpayer with a misdirected tax refund. Under the regulations, a bank is not liable to a third party for any loss resulting from an error in a direct deposit request it receives.[30] If a financial institution receives notice that a direct deposit request has been made for an account not owned by the person whose name is listed on the request, the institution is required

[27] IRM § 21.4.1.4.7.4(3). IRS employees are not permitted to contact the bank to request the identity of the account owner who received the erroneous refund. *Id.*

[28] Information provided by Direct Deposit Tax Force interviews with financial institution representatives that routinely deal with the IRS and FMS.

[29] 31 C.F.R. §§ 210.8 (b), (c) (2005).

[30] 31 C.F.R. § 210.8(b) (2005). Under the regulations, financial institutions are only responsible for errors they make themselves.

to notify the requesting agency.[31] However, the financial institution is not required to return the misdirected funds unless a mistake by the institution caused the refund to be deposited into the wrong account.[32] If the bank did not cause the mistake, it has no obligation to the IRS or the taxpayer.

EXAMPLE 4 – TAXPAYER MISTAKE

Same facts as Example 1, except when Jane learned that her refund was deposited into an account on March 1, 2004, she checked the printout of her 2003 return and realized she had made a mistake – the account number she provided the IRS was off by one number. In this case, the mistake was due entirely to Jane's error. Although this mistake was a minor one, the IRS did exactly as instructed with Jane's refund, and as a result her refund was deposited in someone else's account.

IRS Authority to Remedy

"Want a faster refund? More and more taxpayers are choosing direct deposit as the way to get their federal tax refunds. The payment is more secure – there is no check to get lost. And, it's more convenient – no special trip to the bank to deposit a check."[33] This is the marketing slogan used by the IRS to encourage millions of taxpayers to receive their refund through direct deposit, instead of the traditional paper check. Direct deposit is easier for the IRS and, ideally, more convenient and secure for taxpayers.

Notwithstanding the benefits of direct deposit, there are no procedures – statutory or administrative – that require financial institutions to make efforts to return monies to the IRS if the name(s) on the account and the taxpayer's name are different. That is, as long as the routing number and account number match an actual account, the money is deposited.

A refund erroneously deposited into the account of another is an "erroneous refund" because the incorrect account owner has received money from the IRS to which he or she is not entitled.[34] The receipt of an erroneous refund creates a legally enforceable obligation to repay the money to the IRS.[35] The IRS has a right to bring an erroneous

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31 31 C.F.R. § 210.8(d) (2005).

32 31 C.F.R. § 210.8(b), (c) (2005).

33 IRS, *Faster Refunds through Direct Deposit*, Tax Tip 2005-20 (Jan. 28, 2005).

34 IRM § 21.4.5.2 (Oct. 1, 2004). IRM § 21.4.5.2(2)m lists a direct deposit that is applied to the wrong taxpayer's account as an example of an erroneous refund.

35 IRM § 21.4.5.1 (Oct. 1, 2003).

refund suit against the incorrect account owner to recover the money.[36] The taxpayer, however, cannot utilize this method to recover his or her missing tax refund. Instead, the taxpayer must work through standard IRS procedures.

Once the taxpayer contacts the IRS regarding his or her missing refund, there are a number of steps the IRS employee will take to track down the refund. If ten days have passed from the date the taxpayer electronically filed his or her tax return, the IRS employee will check the routing number for the bank, account type, and account number and initiate a refund trace.[37] If the routing or account number provided by the taxpayer is different from those found on the tax return, the IRS employee will advise the taxpayer to immediately contact the financial institution. The IRS cannot change the numbers on the tax return.[38]

At the same time, the IRS will contact the financial institution. If the financial institution complies with the IRS' request to return the money, the IRS will issue a manual refund to the taxpayer.[39] If the financial institution does not comply with the request to return the refund, the IRS will send the taxpayer a letter explaining what happened to his or her refund. Exhibit 1.19.1 shows a sample letter for this situation.

Exhibit 1.19.1, SAMPLE LETTER[40]

> Our records show that on DATE, your refund of $ *AMOUNT*, was deposited directly into account number ACCT. NOS. at *BANK NAME*, as you requested on your Form *1040/1040a/1040EZ*. Because the account number shown on your return was incorrect, you must contact your financial institution to resolve the erroneous deposit. The Internal Revenue Service does not have the authority to demand the return of the refund from the designated financial institution because the refund deposit went into the account listed on your tax return.

[36] IRC § 7405(b) provides that any portion of a tax imposed under Title 26 which has been erroneously refunded may be recovered by civil action brought in the name of the United States. The IRS can also choose to recover an erroneous refund through a voluntary payment request. IRM § 21.4.5.14(2). To accomplish this, the IRS would address the voluntary payment request letter to the unnamed holder of the account, in care of the financial institution. The IRS would ask that the financial institution deliver the request to the account holder. The request would indicate that the request is voluntary but indicate that, if the amount is large enough, the IRS has the ability to refer the matter for suit.

[37] The direct deposit of a tax refund has a 10 day cycle. Any refund should be directly deposited within 10 days. IRM § 21.4.1.4.7.1 (Mar. 23, 2004). *See also* IRM § 21.4.1.4.7.1(4) (Mar. 23, 2004).

[38] IRM § 21.4.1.4.7.2 (Oct. 1, 2003).

[39] IRM § 21.4.1.4.7.4 (Oct. 1, 2003).

[40] IRM § 21.4.1.4.7.4(5) (Oct. 1, 2003).

IRS Initiatives to Address the Problem

In 2004, in response to inquiries from the Taxpayer Advocate Service, the W&I Accounts Management function created a joint task force to investigate the problem of misdirected tax refunds. The task force's mission was:

- To determine the extent of misapplied direct deposit problems;
- To identify the need for development and implementation of process changes with FMS and financial institutions; and
- To identify opportunities for best practices for Refund Trace Units and increase direct deposit security for taxpayers with deposits that are not recovered.

In June 2005, the task force completed its research and issued its final report. The task force concluded, "although the number of misdirected deposits is minimal, compared to the total [number of] direct deposits, the impact to the taxpayer is substantial."[41] The report noted that there are many barriers to the IRS's ability to adequately resolve the issue of misdirected tax refunds. In response, the task force made a number of recommendations to reduce the problems associated with misdirected tax refunds. The task force's administrative recommendations include:[42]

1. W&I should coordinate with Electronic Tax Administration (ETA) to recommend software update to include verification step for account numbers and routing numbers.
2. W&I and TAS should partner in an education and outreach effort aimed at educating taxpayers on how direct deposits and Refund Anticipation Loan / Refund Anticipation Check systems work.[43]
3. The IRS has an internal process established through the Office of Professional Responsibility (OPR) for reporting tax practitioner misconduct. TAS and W&I should ensure that outreach and educational efforts address the availability of Form 8484, *Report Of Suspected Practitioner Misconduct*, to report misconduct dealing with direct deposit misapplied refunds.
4. W&I should make the "TIP" area on the Form 1040 instructions regarding the RTN and account number for direct deposits more noticeable to the taxpayer.
5. W&I should work with FMS to revise FMS Form 150.1 to include more details to assist in the refund trace process (*i.e.*, account closed/insufficient funds, owner of incorrect direct deposit, action taken by bank, taxpayer indicated the money received was not theirs and should be returned by electronic transfer).
6. W&I and FMS should determine the costs involved in expanding the FMS Tele-

[41] Direct Deposit Task Force, *Direct Deposit Study*, 2 (June 2005).

[42] *Id.* at 3-4.

[43] *See* Most Serious Problems: *Refund Anticipation Loans, Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives, supra.*

Trace system to determine whether it can be an effective alternative to current procedures.[44]

7. W&I should update IRM § 21.4.2 to reduce the timeframe to initiate refund trace on non-receipt direct deposits.
8. W&I should secure approval to improve the automated refund trace process for direct deposit refunds.
9. W&I should develop, and clear through Chief Counsel, a letter to request taxpayer data from financial institutions.

The task force made several legislative recommendations in addition to these administrative proposals. See Additional Legislative Recommendation: Direct Deposit of Income Tax Refunds, for a discussion of the legislative recommendations.

IRS COMMENTS

The IRS appreciates TAS's recognition of the excellent collaborative effort conducted with TAS staff. The Direct Deposit Task Force jointly reviewed this area to determine if there were additional actions that could be taken to prevent misdirected deposits and to lessen taxpayer burden when they occur. We believe reasonable processes are already in place to keep the number of misdirected direct deposit refunds at a minimum. This is evidenced by the very low percentage of direct deposit refunds that enter the trace process.

To address and prevent potential taxpayer or practitioner routing errors, all of the software certified by IRS for IRS e-file contains validity checks of the bank and account numbers (for example, they cannot contain non-numeric characters). Many software products (including the most popular ones) require the banking number/account number to be entered twice to catch typographical errors. In addition, we have improved the "TIP" area in the Form 1040 Instructions to increase the prominence of the routing and account number instructions and cautionary notes regarding the fact that IRS is not responsible for a lost refund if the taxpayer enters incorrect direct deposit information. This is because in situations where monies were accurately directed by IRS to the account specified by the taxpayer, albeit in error, the IRS does not have legal authority to issue a replacement refund.

When a misrouting does occur, our procedures instruct tax examiners to work with FMS, the taxpayer and financial institutions to resolve the misdirected deposit. The IRS will contact the financial institution and request a return of the money. If the financial institution does not comply with our request, the taxpayer is sent a letter explaining what happened to the refund and advising that he or she should contact the institution

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[44] FMS Tele-Trace is a system that, for a fee, will trace any electronic payment made by FMS, eliminating the need for a paper trace. The system currently traces Social Security payments. Financial Management Service, *Payment Trace Requests: Tele-TRACE Nonreceipt Claims Process, available at* http://www.fms.treas.gov/greenbook/nonrecpt/nonrecpt-c6.html (last visited October 13, 2005). The system can be expanded to trace IRS payments, but at a cost to the IRS.

to resolve the erroneous deposit.

The actions the IRS can take are limited due to the requirements enforced by the financial institutions. The process used by financial institutions for determining if a designated bank account is the same as the name of the depositor is a voluntary one. Financial institutions are not required to verify this information. In addition, federal and state banking regulations contribute to the difficulties in securing information to assist in resolving taxpayer misrouting errors. For example, the identity of the party receiving a misdirected refund is rarely known to the Service and is not readily available from banks due to privacy rules.

Contrary to the National Taxpayer Advocate's description of the IRS's authority to remedy this problem, an erroneous refund suit is rarely a viable alternative. While a misdirected deposit by the taxpayer may constitute an erroneous refund, as noted above, the identity of the third-party recipient is rarely known. All the Service has is an account and a routing number. Financial institutions have an obligation to protect the privacy of their customers and, as such, it is unlikely that attempts to secure identifying information with respect to the bank's customers will be voluntarily forthcoming. Even if information regarding the identity of the bank's client was voluntarily made available, determining whether to file suit would also involve considerations of cost, litigation parameters, and statutes of limitations. These factors rarely favor litigation as a recovery vehicle for the government.

As part of our continued commitment to address the concerns raised by the National Taxpayer Advocate, W&I Accounts Management will develop an action plan by December 31, 2005, addressing the recommendations submitted by the Direct Deposit Task Force. In addition, W&I Accounts Management will pursue funding to improve the automated refund trace capability on "Where's My Refund?" and Telephone Routing Interactive System (TRIS).

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the IRS for recognizing the problems caused by misdirected direct deposit refunds. Additionally, the National Taxpayer Advocate thanks Wage & Investment for working collaboratively with the Taxpayer Advocate Service to identify possible ways to improve the direct deposit process and reduce the potential for misdirected tax refunds.

The National Taxpayer Advocate is pleased that the IRS has already begun adopting some of the Direct Deposit Task Force's recommendations by improving the "TIP" area in the Form 1040 Instructions. The National Taxpayer Advocate also supports Wage and Investment Accounts Management's efforts to obtain funding to improve the automated refund trace capability on "Where's My Refund?" and the Telephone Routing Interactive System (TRIS).

The National Taxpayer Advocate acknowledges that the actions the IRS can take to remedy the problems associated with direct deposit refunds are limited due to existing privacy laws regulating the sharing of information by financial institutions. Included in this report is an additional legislative recommendation aimed at developing a formal procedure through which the IRS and financial institutions can work together to recover tax refunds that are deposited into an incorrect account.

Until a legislative change is made, the National Taxpayer Advocate looks forward to reviewing the action plan being developed by Wage and Investment Accounts Management in response to the Direct Deposit Task Force's recommendations. The National Taxpayer Advocate will continue to work with the IRS to identify and develop ways to minimize the potential for a misdirected direct deposit tax refund.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

- Continue to work with financial institutions in an effort to recover misdirect funds.
- Consider all of the recommendations submitted by the Direct Deposit Task Force, as well as any other procedural improvements, that can eliminate the potential for a misdirected direct deposit tax refund.
- Work to educate taxpayers on the importance of accurately listing account information when requesting direct deposit of a tax refund.

PROBLEM

TOPIC #19

MOST SERIOUS PROBLEM: INNOCENT SPOUSE CLAIMS

RESPONSIBLE OFFICIALS

Richard J. Morgante, Commissioner, Wage & Investment Operating Division

David B. Robison, Chief, Appeals

DEFINITION OF THE PROBLEM

Each taxpayer who files a joint return with his or her spouse is jointly and severally liable for tax on all of the couple's income, regardless of who earned or spent the income.[1] Even if married taxpayers file separately, if they are "domiciled" in one of the nine community property states, each is subject to tax on one-half of the "community income," including income earned by his or her spouse.[2]

Recognizing that it may be inequitable to hold one spouse liable for tax on the other spouse's income, at least in cases where he or she does not know about the income or significantly benefit from it, Congress enacted relief rules (generically called "innocent spouse" rules).[3] These rules may relieve a married taxpayer of liability for taxes attributable to a spouse's income (and other items), even if the couple filed a joint return.

Although the IRS has improved the Innocent Spouse Program and is working to make additional improvements, challenges remain.

- *Communication issues.* The IRS has difficulty communicating what is required to qualify for innocent spouse relief. For example, in fiscal year 2005, about 18 percent of the taxpayers requesting innocent spouse relief did not file joint returns for the tax year in question.[4] These taxpayers either did not understand the require-

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1 IRC § 6013(d)(3).

2 *See Poe v. Seaborn*, 282 US 101 (1930). Nine states have community property laws including: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. IRM § 25.18.1 (Exhibit 1) (Feb. 15, 2005).

3 *See* IRC § 6015; IRC § 66. For a more detailed discussion of the requirements for relief under IRC § 6015 and IRC § 66, *see* Key Legislative Recommendation, *Another Marriage Penalty: Taxing the Wrong Spouse*, and Most Litigated Issue: *Relief From Joint and Several Liability For Spouses Under IRC § 6015, infra.* "Innocent spouse relief" is frequently used to describe relief from joint and several liability under IRC § 6015(b). Unless otherwise indicated, however, we use the term "innocent spouse relief" to refer to all types of relief from joint and several liability under IRC § 6015 and relief from application of the community property income allocation rules under IRC § 66. However, because less than one percent of the innocent spouse dispositions in FY 2005 related to relief from community property laws, our discussion focuses on requests for relief from joint and several liability." Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct. 18, 2005).

4 Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct. 14, 2005); Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct. 6, 2005). The 18 percent figure includes taxpayers who did not file any returns for the year in question. Taxpayers do not need to file a joint return to obtain relief from the community property rules. *See* IRC § 66(c). However, as noted above, such requests make up less than 1 percent of all innocent spouse relief determinations.

ments for relief or did not know which year to include on the form.[5]

- *Procedural issues.* IRS campuses sometimes fail to date stamp innocent spouse claims upon receipt. As a result, the IRS may erroneously continue collection action while processing a claim or erroneously treat the claim as untimely. In addition, the IRS generally has no process for reconsidering its innocent spouse determinations. In contrast, pursuant to its "audit reconsideration" process, the IRS will reconsider its other liability determinations, such as those resulting from audits and substitute(s) for returns. There is no apparent reason for the IRS to foreclose its normal reconsideration procedures to taxpayers seeking innocent spouse relief.
- *Processing time.* The IRS's timely resolution of innocent spouse claims is very important to taxpayers.[6] Although both Appeals and Compliance have reduced their innocent spouse processing times, the IRS Appeals function still takes more than a year to process innocent spouse appeals.[7] Thus, taxpayers who appeal Compliance's decision wait for more than two years, on average, for the IRS to reach a final decision.[8]
- *Computer issues – discrepancies between systems.* Various IRS computer systems contain inconsistent information about innocent spouse claims processed by Appeals. These discrepancies make it difficult for the IRS to identify systemic problems with innocent spouse processing.

ANALYSIS OF THE PROBLEM

Background

The National Taxpayer Advocate's 2002 Annual Report to Congress discussed the Innocent Spouse Program as an IRS success story, and the program continues to improve.[9] For example, the IRS:

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[5] Most taxpayers who submit innocent spouse claims are low income singles with dependents. W&I Research, Strategic Forecasting & Analysis, Innocent Spouse Data Summary (Oct. 3, 2005) (providing statistics based on 2001 data). Such taxpayers may have difficulty understanding complicated forms and letters. *See* Carl F. Kaestle, *et. al.*, Center for Education Statistics, U.S. Dept. of Ed., *National Adult Literacy and Education in America: Four Studies Based on the National Adult Literacy Survey*, NCES 1999-469, 28 (Dec. 2001), *available at* http://nces.ed.gov/pubs2001/2001534.pdf (finding a correlation between income and literacy even after adjusting for education).

[6] The Gallup Organization, *Customer Satisfaction Survey, Internal Revenue Service Innocent Spouse*, Quarter 6 Report 18 (Oct. – Dec. 2004).

[7] Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (July 8, 2005) (reviewed by Appeals); Appeals Division, Business Performance Review, 18 (April 26, 2005); Director Appeals Tax Policy and Procedure (SBSE & W&I Programs), Response to Information Request (June 3, 2005).

[8] Appeals Division, Business Performance Review 18 (April 26, 2005); Director Appeals Tax Policy and Procedure (SBSE & W&I Programs), Response to Information Request (June 3, 2005); Policy Analyst, W&I, Reporting Compliance and Policy, Response to Information Request (July 27, 2005).

[9] *See* National Taxpayer Advocate 2002 Annual Report to Congress 150-155.

- Reduced processing time for innocent spouse claims in both Compliance and Appeals.[10]
- Improved the process of separating joint accounts on its computer system.[11]
- Will now accept a faxed signature on the innocent spouse relief request form in certain circumstances, rather than always requiring an original signature.[12]

Challenges remain, however. One of the most significant challenges the program faces is communicating with taxpayers.

Communication Issues

Taxpayers who apply for innocent spouse relief are frequently low income single parents. Sixty-five percent of the taxpayers who request innocent spouse relief make less than $30,000 per year.[13] Thirty four percent are single filers and another 51 percent file as "head of household," meaning they are unmarried and maintain a home for children or certain other persons.[14] Researchers have found a correlation between income and literacy even after taking education into account.[15] Family circumstances, including domestic violence, may also reduce a taxpayer's ability to cope with complexity. Therefore, to be successful, IRS communications with taxpayers applying for innocent spouse relief need to be particularly clear and easy to understand.

Taxpayers may request relief from joint and several liability or the community property rules by filing Form 8857, *Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief)*.[16] One of the IRS's first steps in processing Form 8857 is to determine if the claim is "qualifying" (*i.e.*, meets the basic requirements for consideration) before considering the merits. In FY 2005, the IRS screened out 43 percent of the claims as

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10 *See* Table 1.19.3, *Compliance's Processing Time from Receipt to Preliminary Determination, in Days, by Disposition and Fiscal Year* and Table1.19.4, *Appealed Innocent Spouse Cases/Claims (Nondocketed) Average Processing Time by Fiscal Year and Data Source*, below.

11 *See, e.g.*, IRM § 21.6.8.3 (Oct. 1, 2005). This change partially addresses a problem discussed in our 2003 report. See National Taxpayer Advocate 2003 Annual Report to Congress 170 (Most Serious Problem: Master File Transaction 31 Separating Joint Tax Accounts of Spouses).

12 *See* IRM § 21.3.4.14.5 (Dec. 1, 2004).

13 W&I Research, Strategic Forecasting & Analysis, Innocent Spouse Data Summary (Oct. 3, 2005) (providing statistics based on 2001 data).

14 W&I Research, Strategic Forecasting & Analysis, Innocent Spouse Data Summary (Oct. 3, 2005) (providing statistics based on 2001 data.

15 *See* Carl F. Kaestle, *et. al.*, Center for Education Statistics, U.S. Dept. of Ed., *National Adult Literacy and Education in America: Four Studies Based on the National Adult Literacy Survey*, NCES 1999-469, 28 (Dec. 2001), *available at* http://nces.ed.gov/pubs2001/2001534.pdf.

16 Sometimes taxpayers raise innocent spouse issues in a Collection Due Process hearing or in litigation. *See, e.g.*, IRM § 5.1.9.3.5(6) (Aug. 1, 2005). As noted above, because less than one percent of the Form 8857 dispositions in FY 2005 related to relief from community property laws, our discussion focuses on requests for relief from joint and several liability.

"nonqualifying" without reaching the merits.[17] This percentage has remained relatively constant over the last few years, as shown on the following table.

TABLE 1.19.1, FORM 8857 DISPOSITIONS BY FISCAL YEAR[18]

Dispositions	FY 2003		FY 2004		FY 2005[19]	
Nonqualifying	24,604	44%	23,721	42%	20,599	43%
Disallowed in Full	20,332	36%	19,845	35%	14,068	29%
Partially Allowed	3,597	6%	3,804	7%	3,830	8%
Allowed in Full	7,550	13%	9,788	17%	9,964	21%
Total	56,083		57,158		48,461	

Most taxpayers would only spend time and effort submitting a claim if they thought the IRS would provide relief. However, fewer than three in ten taxpayers who submit claims receive any relief from Compliance, as shown on Table 1.19.1, *Form 8857 Dispositions by Fiscal Year*, above.

To its credit, the IRS recognizes the high rate at which taxpayers submit claims that the IRS deems nonqualifying or disallows is a problem. It recently formed a team, which includes a TAS representative, to revise Form 8857 and improve the program.[20]

The high rate at which taxpayer claims are nonqualifying or disallowed suggests that either the IRS does not effectively communicate the requirements for relief or is improperly screening out or disallowing claims. Internal quality measures indicate the IRS is correctly applying the rules in resolving innocent spouse claims.[21] If we assume

[17] Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct. 14, 2005).

[18] *Id.* Table 1.19.1, *Form 8857 Dispositions by Fiscal Year* reflects the number of claims. On average, each taxpayer submits claims for 1.9 tax years. *Id.* Percentages do not add to 100 due to rounding.

[19] The IRS also re-worked 1,617 claims in FY 2005, which are not reflected on Table 1.19.1, *Form 8857 Dispositions by Fiscal Year*. Email from Policy Analyst, W&I, Compliance Reporting Compliance to TAS (Oct. 24, 2005). In addition, the number of nonqualifying dispositions shown on Table 1.19.1, *Form 8857 Dispositions by Fiscal Year*, does not match the number shown on Table 1.19.2, *Reasons for Nonqualifying Claims* because Table 1.19.1 includes all claims but Table 1.19.2, only includes claims processed by Cincinnati Centralized Innocent Spouse Operations (CCISO). *Id.*

[20] National Taxpayer Advocate FY 2006 Objectives Report to Congress, Appendix III-1. In addition, the SB/SE Office of Burden Reduction asked IRS research to identify problems that taxpayers have with Form 8857. *See* Office of Program Evaluation and Risk Analysis, Analysis of Form 8857 Error Rates (Mar. 22, 2005). The IRS also solicited IRS employee suggestions to improve the Innocent Spouse Program. IRS Headlines (Aug. 29, 2005).

[21] Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct 14, 2005) (indicating that IRS achieves 93 percent "customer accuracy"). TIGTA recently reviewed a sample of IRS's innocent spouse determinations that had been reviewed by the Innocent Spouse Centralized Review function between November 1, 2003 and April 10, 2004. Treasury Inspector General Tax Administration, Ref. No. 2005-40-075, *The Innocent Spouse Centralized Review Function Ensured Accurate Relief Determinations, but Improvements Could Increase Customer Service* 5 (May 2005). Although TIGTA did not review the accuracy of IRS's screening process, it determined that IRS Examiners properly resolved the taxpayer's case or issue in 94 percent of the reviewed cases (120 out of 128). *Id.*

that Compliance reaches the correct result in most cases, the large number of nonqualifying or denied claims suggests that it has difficulty communicating with taxpayers.[22]

Some taxpayers have more success communicating with Appeals than with Compliance. The Appeals function granted additional relief to taxpayers in about 35 percent of the claims in FY 2005.[23] The relatively large percentage of claims receiving more relief in Appeals than in Compliance could indicate that Compliance makes errors not reflected in its quality measures. However, a more likely explanation is that Appeals is more successful in communicating with taxpayers than Compliance so that Appeals decisions are based on relevant information that Compliance did not consider.[24]

According to the IRS, taxpayer claims are nonqualifying for the following reasons, which have remained relatively constant over the last few years.

[22] Note that the Innocent Spouse Program does not have a toll free number for taxpayers to call to inquire about innocent spouse information. IRS, Office of the Notice Gatekeeper, *The Source for Telephone Numbers* (query conducted Sept. 12, 2005). The absence of a toll free number may contribute to communication difficulties.

[23] Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct. 25, 2005) (indicating that in FY 2005 Appeals allowed more relief than Compliance in 2,145 claims and that it allowed less relief or sustained Compliance's determination in 4,023 claims). Similarly, in FY 2005, taxpayers obtained more relief in Tax Court in 49 percent of the claims. *Id.* (indicating that in FY 2005 the Tax Court allowed more relief than Appeals in 233 claims, allowed less relief in 3 claims, and sustained Appeals' determination in 239 claims).

[24] We note that Appeals' ability to effectively communicate with taxpayers may be impaired as it moves away from face-to-face or local appeals meetings. *See* Most Serious Problem, *Appeals Campus Centralization, supra.* Indeed, the percentage of taxpayers receiving more relief in Appeals declined from 42 percent in FY 2004. By itself this data might suggest that Compliance is simply getting the right answer more often so that Appeals does not need to reverse its decisions. But, the percentage of taxpayers who received more relief after petitioning the Tax Court has increased from 46 percent in FY 2004 (349 of 760 claims), to 49 percent in FY 2005 (233 of 472 claims). *Id.* This trend does not support the conclusion that Compliance is getting it right more often, at least with respect to claims petitioned in Tax Court. *Id.*

TABLE 1.19.2, REASONS FOR NONQUALIFYING CLAIMS FY 2004 - FY 2005[25]

Reason	FY 2004		FY 2005	
Full Paid: Claim filed for a tax year with no understatement or underpayment.[26]	6,683	28%	6,077	29%
Filing Status: Claim filed for a tax year in which the claimant did not file a joint return.	5,333	22%	4,550	22%
No Return: No return filed for the year in question.	4,453	19%	3,998	19%
Unprocessable: After additional correspondence claimant did not provide basic information (*e.g.*, signature, SSN, or tax year).	2,523	11%	2,128	10%
Injured Spouse: Claimant incorrectly filed for innocent spouse relief when they should have filed for injured spouse relief.	1,489	6%	1,305	6%
Invalid Joint Return: Claimant was not married at the end of the year in question or did not sign the return.	785	3%	896	4%
Withdrawn: Claimant withdrew the claim.[27]	816	3%	613	3%
Collection Statute Barred: Period for collection of tax expired (no tax owed).	823	3%	528	3%
Other	816	3%	721	3%
Total	**23,721**		**20,816**	

Incorrect Year Frequently Entered on Form 8857

IRS personnel who process Form 8857 told TAS that most of the nonqualifying dispositions listed as "full paid," "filing status," "no return" and "unprocessable" result because taxpayers enter the wrong year on the form.[28] These categories collectively account for 80 percent of the nonqualifying dispositions.[29] Taxpayers can only receive innocent spouse relief for a year in which they filed a joint return and have a tax understatement or underpayment.[30] If a taxpayer filed a return but did not have an understatement or underpayment for the year indicated on Form 8857, the IRS would classify the claim

[25] Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct. 6, 2005). Percentages do not add up to 100 due to rounding.

[26] An "understatement" of tax or "deficiency" is generally the difference between the amount of tax that the IRS determines should have been shown on the return and the amount actually shown on the return. *See* Form 8857, *Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief)* 2 (Feb. 2004).

[27] The IRS will contact the nonrequesting spouse in order to process the claim. *See* Treas. Reg. § 1.6015-6; IRM § 25.15.3.3.1 (May 1, 2005). *See also* IRC § 6015(e)(4) (requiring the Tax Court to establish rules to provide notice of proceedings to the nonrequesting spouse). If the requesting spouse does not want the IRS to contact the nonrequesting spouse, the requesting spouse must withdraw the claim.

[28] Meeting with Cincinnati Centralized Innocent Spouse Operations (CCISO) personnel (May 24, 2005). "Collection Statute Barred" rejections may also be due to an incorrect year on Form 8857. IRS research concluded that during FY 2002 through FY 2004 31.5 percent of all taxpayers who submitted claims did not include any qualifying tax years. See Office of Program Evaluation and Risk Analysis, *Analysis of Form 8857 Error Rates* 9 (Mar. 22, 2005). It observed that neither the decision trees in Publication 971 nor the innocent spouse eligibility explorer on the IRS website explicitly guides the taxpayer to identify the correct tax years to claim on Form 8857. *Id.* at 11.

[29] *See* Table 1.19.2, *Reasons for Nonqualifying Claims*, above.

[30] *See* IRC § 6015. Taxpayers do not need to file a joint return to obtain relief from the community property rules. *See* IRC § 66(c). However, as noted above, such requests make up less than 1 percent of all innocent spouse relief determinations.

as "fully paid." If a taxpayer did not file a joint return for the year indicated on Form 8857, the IRS would classify the claim as nonqualifying either based on "filing status" or "no return," depending on whether he or she filed a separate return or none at all. If a Form 8857 did not specify any year, the IRS would classify the claim as "unprocessable." IRS employees explained that taxpayers often enter the current year, or the year in which the IRS took their refund, on Form 8857, rather than the year of the joint understatement or underpayment.[31] This explanation suggests that the IRS could significantly reduce nonqualifying claims by more effectively communicating the requirements for innocent spouse relief and the year that taxpayers should include on Form 8857.[32]

Innocent Spouse vs. Injured Spouse Form

The fact that about six percent of all nonqualifying claims should have been requests for injured spouse relief, as shown on Table 1.19.2, *Reasons for Nonqualifying Claims*, further illustrates the IRS's communications difficulties. However, even if the IRS effectively communicates to taxpayers the circumstances in which they should apply for innocent spouse rather than injured spouse relief, taxpayers still may not be able to determine which form to use.[33] For example, if the IRS offsets a taxpayer's refund against a prior year's joint liability, then innocent spouse relief may apply, but if the IRS offsets the refund against the separate liability of the taxpayer's spouse, then injured spouse relief may apply. Determining the proper form requires the taxpayer to find out against which liability the IRS offset his or her refund. Since the taxpayer may not always know how the IRS has applied his or her refund, the IRS is asking the taxpayer to choose the correct form based on information that the IRS has, but that the taxpayer may not have.[34]

Taxpayers Not Informed of Retroactive Change to Period for Submitting Claims

Pursuant to the October 2004 Tax Court opinion in *McGee v. Commissioner*, the period for submitting claims was retroactively extended for many taxpayers.[35] However, the IRS has not informed taxpayers whose claims it previously rejected as untimely of their right to have the IRS consider their claims on the merits.

Taxpayers generally must file claims for relief within the two-year period beginning on

[31] Meeting with Cincinnati Centralized Innocent Spouse Operations (CCISO) personnel (May 24, 2005).

[32] The IRS often knows which years the taxpayer should put on Form 8857. When a taxpayer's claim is nonqualifying because the taxpayer indicated the wrong year on Form 8857, the IRS sends the taxpayer a letter indicating which years have joint liabilities with a balance due and inviting them to submit a claim for those years. *See, e.g.*, IRM Exhibit § 25.15.3-21 (May 1, 2005) (Letter 3758 – Unprocessable); IRM Exhibit § 25.15.3-24 (May 1, 2005) (Letter 3659A - Initial Contact Letter to RS – PANES).

[33] Form 8857, *Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief)*, includes instructions that refer taxpayers to the injured spouse form.

[34] Even assuming a taxpayer received a refund offset notice that provided such information, he or she may not understand it or may not have the notice handy when filling out Form 8857.

[35] *See McGee v. Commissioner*, 123 T.C. 314 (2004).

the date of the IRS's first collection activity against them with respect to the liability.[36] In *McGee v. Commissioner*, the Tax Court held that a refund offset will not trigger the two-year period for filing a claim unless and until the IRS notifies the taxpayer of his or her right to innocent spouse relief.[37] The IRS did not routinely provide such notice in connection with refund offsets until January or February 2005.[38] Thus, taxpayers who submitted innocent spouse claims more than two years after a refund offset but less than two years after they received notice of their right to innocent spouse relief may still be eligible to have the IRS consider their claims (called "McGee claims").

The IRS reconsidered 1,617 McGee claims that were open at the time the Tax Court rendered its opinion, but did not automatically reconsider 6,002 McGee claims that it previously denied as untimely.[39] The IRS did not inform these taxpayers of their right to resubmit their claims.[40] Thus, many taxpayers who submitted McGee claims that the IRS closed as untimely may remain unaware of their right to have the IRS consider them. This omission is another example of the IRS' difficulty in communicating with taxpayers.

Procedural Issues

No Date Stamp

Employees of the Cincinnati Centralized Innocent Spouse Operations (CCISO), who generally process innocent spouse claims, tell us that other IRS campuses do not always date stamp Forms 8857 upon receipt in accordance with procedures.[41] According to CCISO personnel, other campuses sometimes hold the form for a week or longer, until they have a full box, before sending them to CCISO, in violation of IRS procedures.[42] If there is no date stamp on the Form 8857 when CCISO receives it, that unit's employees use the date on which they receive the form as the receipt date.[43] Thus, when other IRS campuses receive Forms 8857, the receipt dates shown in IRS computers may be more than a week after the IRS actually received them.

[36] IRC § 6015(b)(1)(E); IRC § 6015(c)(3)(B); Treas. Reg. §§ 1.6015-5(b)(1), -5(b)(5); Rev. Proc. 2003-61, 2003-32 I.R.B. 296 § 4.01(3) and § 5; IRM § 25.15.5.11.1 (Sept. 1, 2003).

[37] *See McGee v. Commissioner*, 123 T.C. 314 (2004). The IRS now agrees that the two-year period for submitting a claim begins after the IRS sends the taxpayer a notice informing her of her right to relief, unless the IRS can show that the taxpayer had actual knowledge of his or her right to file a claim for relief. *See* Chief Counsel Notice CC-2005-010 (May 20, 2005).

[38] *See McGee v. Commissioner*, 123 T.C. 314 (2004); Chief Counsel Notice CC-2005-010 (May 20, 2005); IRM § 25.15.3.4.4 (May 1, 2005).

[39] Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Aug. 31, 2005).

[40] *Id.*

[41] Meeting with Cincinnati Centralized Innocent Spouse Operations (CCISO) personnel (May 24, 2005) (indicating that other campuses do not always follow the date stamping procedures outlined in IRM § 25.15.2.4 (May 1, 2005)).

[42] Meeting with Cincinnati Centralized Innocent Spouse Operations (CCISO) personnel (May 24, 2005). IRM § 25.15.2.4 (May 1, 2005).

[43] Meeting with Cincinnati Centralized Innocent Spouse Operations (CCISO) personnel (May 24, 2005).

Such inaccuracies may cause problems for taxpayers. The IRS stops all collection actions against a taxpayer, including refund offsets, when it receives Form 8857.[44] CCISO staff indicated that taxpayers sometimes file Form 8857 claiming innocent spouse relief for a prior year along with their current year income tax return, hoping that the IRS will not offset their tax refund for the current year. The taxpayer sends the Form 8857, along with his or her return, to the appropriate IRS campus for processing the return, rather than to CCISO.[45] The campus' failure to date stamp Form 8857 may cause the IRS to erroneously continue collection activities (including refund offsets) after receiving the claim. It may also cause the IRS to improperly reject claims as untimely.

No Audit Reconsideration Process for Innocent Spouse Determinations

Most taxpayers who submit innocent spouse claims are low income single parents who may have difficulty understanding what the IRS needs to process their claims.[46] Nevertheless, except in limited circumstances, once Compliance disallows an innocent spouse claim and issues a final notice of determination, it will not reconsider its decision.[47] In contrast, after an audit that results in a deficiency assessment, the taxpayer has an opportunity to request "audit reconsideration" by Compliance if he or she provides additional information not considered during the original examination.[48] Taxpayers may also request audit reconsideration after the IRS files a substitute for return or makes a computational or processing error that they would like the IRS to reconsider.[49] Moreover, audit reconsideration is available to taxpayers who have missed

44 IRC § 6015(e)(1)(B)(i) (prohibiting levies while IRS processes a claim); IRM § 25.15.2.4.2 (May 1, 2005) (prohibiting "all" collection activity while IRS processes a claim, including refund offsets).

45 The instructions to Form 8857 state that the form should be mailed to CCISCO. *See* Form 8857, *Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief)* 2 (Feb. 2004). If taxpayers mail Form 8857 to another IRS campus, in some cases, CCISCO may never receive it. TIGTA recently found no evidence that the IRS had processed tax return attachments (such as Form 8857) in three percent of the 350 cases that it reviewed, and in another nine percent it could not verify that the IRS took appropriate action to process attachments because processing information was not available when the review took place. *See* Treasury Inspector General for Tax Administration, Ref. No. 2004-40-153, *Most Attachments Submitted With Individual Taxpayers' Tax Returns Are Identified and Processed* 2 (Sept. 2004).

46 *See* Carl F. Kaestle, *et. al.*, Center for Education Statistics, U.S. Dept. of Ed., *National Adult Literacy and Education in America: Four Studies Based on the National Adult Literacy Survey*, NCES 1999-469, 28 (Dec. 2001), *available at* http://nces.ed.gov/pubs2001/2001534.pdf (finding a correlation between income and literacy even after adjusting for education); W&I Research, Strategic Forecasting & Analysis, Innocent Spouse Data Summary (Oct. 3, 2005) (providing statistics based on 2001 data, which show that the typical taxpayer who submits an innocent spouse claim makes less than $30,000 per year and files as a single head of household). We use the term "parents" loosely to refer to taxpayers filing as head of household.

47 *See* IRM § 25.15.7.4.2.2 (May 1, 2005) (indicating that IRS should automatically disallow claims on the "first read" that were previously disallowed unless the marital status of the requesting spouse has changed); IRM § 25.15.7.10.10 (May 1, 2005) (limiting innocent spouse "rework" to cases where the IRS has only made a preliminary determination). *See also*, Treas. Reg. § 1.6015-5(c). However, in very limited circumstances, Compliance will issue a second final notice of determination. *See* IRM § 25.15.7.10.10 (May 1, 2005).

48 *See* IRM § 4.13.1.4(1)(d) (Feb. 1, 2003); IRM § 1.2.1.3.16 (Sept. 20, 1999) (Policy Statement P-2-89). Sometimes taxpayers request audit reconsideration because they did not appear for the audit, moved and did not receive IRS correspondence, or have new documentation to present. *See* IRM § 4.13.1.3 (Feb. 1, 2003).

49 *See* IRM § 4.13.1.6 (Feb. 1, 2003).

their opportunity to have Appeals review Compliance's determination.[50]

One primary purpose of the audit reconsideration process is to help ensure that assessed liabilities are correct and that the IRS resolves cases with similar facts in a consistent manner.[51] Thus, the IRS policy of not reconsidering its innocent spouse determinations means some taxpayers (often low-income single parents) will be denied relief even though they would otherwise be entitled to it and the IRS will not resolve some cases with similar facts consistently.

Processing Time

According to a survey conducted by the Gallup Organization, resolving innocent spouse claims in a timely manner is one of the items with the greatest potential impact on taxpayer satisfaction with the Innocent Spouse Program.[52] It is understandably stressful for taxpayers to have unresolved tax issues outstanding for long periods.

Compliance's acceptable processing times vary depending upon the disposition of the case, as shown on the following table.

50 *See, e.g.*, IRM § 8.20.5.4.17 (Jan. 31, 2002).

51 *See* IRM § 4.13.1.1(2) (Feb. 1, 2003).

52 The Gallup Organization, *Customer Satisfaction Survey, Internal Revenue Service Innocent Spouse*, Quarter 6 Report 18 (Oct. – Dec. 2004).

TABLE 1.19.3, COMPLIANCE'S ACCEPTABLE PROCESSING TIME FOR TYPICAL INNOCENT SPOUSE CLAIMS[53]

1. Initial screening			15 days
2. Order administrative file, request additional information from requesting spouse and send notice to nonrequesting spouse			10 days
3. Wait to receive taxpayer correspondence[54]			45 days
4. Make a preliminary determination[55]			75 days
5. Computer generates and mails **preliminary determination** letter			10 days
6. Wait for either spouse to Appeal			30 days
7. Wait to receive taxpayer correspondence, issue **final determination** letter			15 days
Subtotal			200 days
	Allowed in Full	**Partially Allowed**	**Denied in Full**
8. Wait for taxpayer to petition Tax Court	—	90 days	90 days
9. Wait for notice that petition was filed	—	20 days	20 days
10. Update account(s) on IRS computer system(s)	30 days	30 days	30 days
Total	**230 days**	**340 days**	**340 days**

Although these periods are perhaps surprisingly long, much of Compliance's processing time – about 130 days for allowed claims and 240 days for other claims (steps 3, 5, 6, 7, 8, 9, 10) – involves waiting for information from taxpayers or IRS computer systems.[56] In addition, some this processing time occurs after the taxpayer has received a final determination. In FY 2005, Compliance significantly reduced the time it takes to process most claims, in part, because it recently improved the process of separating joint accounts on IRS computer systems.[57] The following table shows the time that Compliance actually takes to determine that a claim is nonqualifying or reach a preliminary determination (step 5).

[53] Senior Tax Analyst, W&I, Compliance Reporting Compliance, Response to Information Request (Oct. 5, 2005); Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct. 18, 2005). Processing time goals are extended during peak processing seasons, when IRS computer systems will not update the account (*i.e.*, a change is "unpostable"), and when a taxpayer's spouse (or former spouse) is potentially abusive. The table only reflects processing time for CISCO and does not reflect processing times for Appeals or other IRS employees.

[54] Steps 2 and 3 are not "overage" unless they take more than 62 days (not 55 days). Cases that are overage may receive special attention.

[55] Step 4 is not "overage" unless it takes longer than 120 days (not 75 days).

[56] Step 8 and part of step 2 are required by law. See IRC § 6015(h)(2); Treas. Reg. § 1.6015-6 (requiring notice to the nonrequesting spouse); IRC § 6015(e)(4) (requiring the Tax Court to establish rules to provide notice of proceedings to the nonrequesting spouse); IRC § 6015(e)(1)(II) (providing that taxpayers have 90 days after the final determination to petition the Tax Court). In addition, Compliance sends a letter to the taxpayer, which states that obtaining information from the nonrequesting spouse will take about three months and that it could take an additional six months (for a total of nine months or about 270 days) to reach a preliminary determination. Letter 3659C (Nov. 3, 2003).

[57] *See, e.g.*, IRM § 25.15.13.6.1 (May 1, 2005) (discussing the new "MFT 31" account mirroring process).

TABLE 1.19.4, COMPLIANCE'S PROCESSING TIME FROM RECEIPT TO PRELIMINARY DETERMINATION, IN DAYS, BY DISPOSITION AND FISCAL YEAR[58]

Disposition	FY 2003	FY 2004	FY 2005
Nonqualifying (initial screening)	30	30	22
Allowed in Full	219	232	192
Partially Allowed	271	253	223
Disallowed in Full	214	202	184

Although the IRS significantly reduced processing times in FY 2005, the average times reflected above do not meet IRS goals for making a preliminary determination.

Delays Processing Appealed Claims

Compliance takes much longer to reach a preliminary determination on claims ultimately appealed to the Appeals function – about 330 days in FY 2004 and 256 days in FY 2005.[59] Further, the periods reflected on Table 1.19.3, *Compliance's Acceptable Processing Time for Typical Innocent Spouse Claims*, and Table 1.19.4, *Compliance's Processing Time from Receipt to Preliminary Determination, in Days, by Disposition and Fiscal Year*, do not include the time Appeals takes to make a determination. Both Compliance and Appeals have reduced their processing times in FY 2005.[60] However, nondocketed claims that taxpayers appealed to the IRS' Appeals function still took about 807 days – over two years – for the IRS to process in FY 2005, according to the Innocent Spouse Tracking System (ISTS).[61] The 807 day period includes 256 days in Compliance, 27 days in transit, and 524 days in Appeals.[62] Thus, Appeals took more than twice as long as Compliance to process each case.

Computer Issues – Discrepancies between ISTS and ACDS

Discrepancies between the Appeals Centralized Database System (ACDS) and Innocent Spouse Tracking System (ISTS) may hinder the IRS's ability to identify and address the source of any delays. ACDS shows that in FY 2005, Appeals took 426 days, on

[58] Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct. 14, 2005). Claims that the IRS determines to be nonqualifying after initial screening are not included in the table.

[59] Response to Information Request (June 3, 2005); Policy Analyst, W&I, Reporting Compliance and Policy, Response to Information Request (July 27, 2005).

[60] However, Appeals cycle time has increased slightly from FY 2002 to FY 2005. Policy Analyst, W&I, Reporting Compliance and Policy, Response to Information Request (Oct. 14, 2005).

[61] Policy Analyst, W&I, Reporting Compliance and Policy, Response to Information Request (Oct. 14, 2005). In April 2005, Appeals proposed to assign a group of 16 Appeals Officers to work all substantially unstarted innocent spouse cases assigned in the Field offices. Appeals Division, Business Performance Review, 26 (April 26, 2005).

[62] Policy Analyst, W&I, Reporting Compliance and Policy, Response to Information Request (Oct. 14, 2005).

average, to process innocent spouse cases.[63] In contrast, ISTS data for FY 2005 indicates that Appeals took 524 days to process claims, as shown on Table 1.19.5, *Appealed Innocent Spouse Cases/Claims (Nondocketed) Average Processing Time by Fiscal Year and Data Source*, below.[64] According to the ISTS, it took 27 days to acknowledge receipt of appealed claims in FY 2005 and on October 2, 2005, 2,653 claims were in transit between Compliance and Appeals.[65] One possible, but perhaps unlikely, explanation for the processing time discrepancy between ACDS and ISTS is that claims wait for about 125 days (524 Appeals ISTS processing time + 27 ISTS transit time – 426 Appeals ACDS processing time), on average, after Compliance sends them to Appeals before Appeals tracks them as part of its inventory on ACDS for cycle time purposes. Appeals' average cycle time on ISTS should not be exactly the same as its cycle time on ACDS because ISTS averages reflect the time to process a **claim** and ACDS averages reflect the time to process a **case**. However, such differences should not account for a 125-day discrepancy.

TABLE 1.19.5, APPEALED INNOCENT SPOUSE CASES/CLAIMS (NONDOCKETED) AVERAGE PROCESSING TIME BY FISCAL YEAR AND DATA SOURCE[66]

	FY 2004		FY 2005	
	ISTS Claims	ACDS Cases	ISTS Claims	ACDS Cases
Compliance processing time	330 days	—	256 days	—
Appeals time to acknowledge receipt	45 days	—	27 days	—
Appeals processing time	545 days	450 days	524 days	426
Total processing time	920 days	—	807 days	—

Similar discrepancies exist between ISTS and ACDS with respect to Appeals inventory. According to ACDS, Appeals had 3,305 innocent spouse cases in inventory as of September 30, 2005, whereas the ISTS shows Appeals had 9,559 claims on October 2, 2005.[67] The fact that each case involves 1.9 claims, on average, does not fully explain this discrepancy.[68] If we assume that the 3,305 cases shown in ACDS each represent 1.9 claims, those cases should involve about 6,280 fewer claims (3,305 cases x 1.9 claims per

63 Director Appeals Tax Policy and Procedure (SBSE & W&I Programs), Response to Information Request (June 3, 2005). The term "cases" refers to each taxpayer who has a "claim." Each case involves one or more claims. ACDS tracks cases, but ISTS tracks claims.

64 Policy Analyst, W&I, Reporting Compliance and Policy, Response to Information Request (July 27, 2005).

65 Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct. 14, 2005).

66 Appeals Division, Business Performance Review, 18 (April 26, 2005); Director Appeals Tax Policy and Procedure (SBSE & W&I Programs), Response to Information Request (Oct. 21, 2005); Policy Analyst, W&I, Reporting Compliance and Policy, Response to Information Request (Oct. 14, 2005).

67 Appeals Division, Business Performance Review 17 (April 26, 2005); Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (July 8, 2005).

68 Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (July 8, 2005).

case), which is still 3,279 (9,559 - 6,280) fewer claims than the 9,559 claims that ISTS shows in Appeals inventory.[69]

The most likely explanation for the discrepancy between ACDS and ISTS cycle time and inventory measures is that Appeals personnel do not consistently update ISTS when they close a case as procedures require.[70] Appeals is aware of the discrepancy between ACDS and ISTS and plans to develop an automated process for updating ISTS.[71] However, the IRS's failure to consistently and reliably measure the time that it takes cases to move from Compliance to Appeals will make it difficult for IRS management to know when claims are subject to unreasonable delay and to address such problems when they arise.

IRS COMMENTS

Communication Issues

As a result of problems encountered with *Form 8857, Request for Innocent Spouse Relief*, the IRS formed a Redesign Task Team in June 2005. The team's goal is to reduce the number of non-qualified and disallowed innocent spouse claims. We solicited suggestions on how to improve the form, instructions, and questionnaire from employees and the Taxpayer Advocacy Panel (TAP). A plain language contractor was also secured to assist the team. Issues, such as, entering the correct year and clarifying the use of innocent spouse versus injured spouse are currently being reviewed by the task team. One of the recommendations of the team is to secure a toll-free number for taxpayers to use if they have questions about seeking innocent spouse relief.

The National Taxpayer Advocate's report asserts that some taxpayers have more success communicating with Appeals than with Compliance based on the number of claims receiving relief in Appeals. There are a myriad of reasons why a taxpayer is denied relief by the Cincinnati Centralized Innocent Spouse Operation (CCISO) but subsequently receives relief in Appeals. Often, however, it is because the taxpayer refuses to supply the information requested by CCISO to process their claim. When the claim is closed and disallowed, the taxpayer appeals the determination and then supplies the requested information to Appeals. We believe CCISO provides considerable opportunity for communication as reflected in the following excerpt extracted from the recently closed TIGTA audit of the CCISO Operation,

> We found examiners made accurate determinations in 100 percent of the 128 closed quality-reviewed cases we sampled. During Fiscal Year

[69] Director Appeals Tax Policy and Procedure (SBSE & W&I Programs), Response to Information Request (Oct. 21, 2005); Policy Analyst, W&I, Reporting Compliance and Policy, Response to Information Request (Oct. 14, 2005).

[70] IRM § 25.15.12.6(5) (Sept. 1, 2003); IRM § 25.15.12.10 (Sept. 1, 2003).

[71] Director Appeals Tax Policy and Procedure (SBSE & W&I Programs), Response to Information Request (June 3, 2005).

> (FY) 2004,[72] 6,555 taxpayers were granted full or partial relief from approximately $117.6 million in tax assessments. The examiners and managers, in concert with the quality reviewers, ensured these determinations were fair, equitable, and accurate. In addition, examiners generally provided taxpayers with timely preliminary and final determination letters, avoiding unnecessary delays and efficiently processing additional taxpayer information.

All requests for reconsideration received from taxpayers that contacted the IRS because of the court decision in *McGee v. Commissioner* were honored. In addition, CCISO reworked all existing open impacted claims. However, we will review the procedures used for those cases that were closed prior to the decision in *McGee*. It should also be noted that IRS issued a notice that was published in the Federal Register with guidance on the *McGee* decision and publication of the notice did receive media coverage.

Procedural Issues

While the National Taxpayer Advocate states that some claims are not date stamped, leading to erroneous collection actions, our data indicates that 98.5 percent of all innocent spouse claims filed are received directly by CCISO. Of these claims, all are date stamped upon receipt and collection activity is stopped on the date received. In addition, they are currently screened within two business days. The remaining 1.5 percent are claims not initially received directly into CCISO and only a small percentage of these do not have original received date stamps. In these instances, CCISO examiners are instructed to determine the received date by looking at the envelope or any correspondence attached. Any collection action erroneously taken after the received date on this small population of claims is refunded to the taxpayer.

The IRS will reconsider our determination if additional information is received after a denial letter is issued but prior to issuance of the final determination letter. Except in limited circumstances, the statute does not permit the IRS to apply the same audit reconsideration procedures to innocent spouse claims as it uses for audit deficiency assessments.

Processing Time

As recognized in the National Taxpayer Advocate's report, Appeals and Compliance functions continue to reduce innocent spouse processing times. The cycle time for an innocent spouse determination made by CCISO decreased from 232 days in Fiscal Year (FY) 2004 to 189 days in FY 2005. As of November 2005, determination letters were issued on requests from June 2005. Appeals restructured its operations to devote specialized resources to resolving innocent spouse cases quickly and accurately. There are now two campus operations working these issues. The centralization of the Appeals Innocent

72 According to Innocent Spouse Program management, tracking of the FY 2004 Innocent Spouse Program results began on September 28, 2003, and ended on September 25, 2004.

Spouse Operation resulted in a significant reduction in cycle time in FY 2005 to 246 days. As these operations mature, further improvements in Appeals cycle time is expected.

In March 2005, Appeals created a specialized field team to resolve the older innocent spouse inventory. As of November 2005, the team closed a backlog of 238 cases in Appeals field operations' inventory and moved another 137 cases into "final determination" status. The transition of this inventory from the field offices to the two centralized operations resulted in significant cycle time improvements. Closed cases from the field operations averaged 425 days versus 246 days open from the campus operations.

Computer Issues

There are several other initiatives underway to improve the Appeals Innocent Spouse program, particularly in reducing processing time, reporting of case resolution data, and resolving discrepancies between computer systems. This includes creating an automated closing document for innocent spouse cases to provide better reporting on case resolution; and implementing an automated match of the Innocent Spouse Tracking System (ISTS) and Appeals Centralized Database System (ACDS).

The ISTS is a system that records all activity taken on an innocent spouse claim. Appeals is required to keep ISTS current. As noted in the MSP, it has been determined numerous Appeals cases were closed but were not updated on ISTS which contributed to the cycle time. We are currently in the process of updating ISTS to show the cases as closed. Any delays identified through ISTS by CCISO are forwarded to Appeals for resolution, with close coordination between the staffs of both organizations.

In addition to recording data on ISTS, Appeals maintains another database called the Appeals Centralized Database System (ACDS). ISTS and ACDS systems were designed for different purposes and each measures different outcomes. The differences between ACDS and ISTS do not hinder the IRS' ability to identify and address the source of any delays. A comparison of the data, as mentioned in the Advocate's report, is difficult because of the different methods of reporting. Not only is there a difference between ACDS cases (reporting taxpayer units) versus ISTS claims (reporting tax years), there are differences in the dates used to capture cycle time measures in each system.

It is important to ensure the systems capture inventory and disposal information accurately and that each system contain accurate information about each case. Appeals and CCISO partnered to develop a methodology to reconcile and validate ACDS and ISTS data. During FY 2005, an automated program was developed to match ACDS and ISTS inventories. This will ensure the two systems account for all cases and they are all in the same status. Initial programming of ISTS/ACDS validation reports (reports that match ACDS to ISTS) was deployed to ACDS on February 16, 2005. Additionally, Appeals and CCISO are jointly pursuing an automated option to automatically make the updates between the two systems in order to save time and enable staff to redirect this time to resolving taxpayer issues.

PROBLEMS

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the IRS on its significant improvements to the Innocent Spouse Program, as discussed above. However, the program still faces some challenges. The National Taxpayer Advocate makes the following recommendations to address these challenges:

RECOMMENDATIONS

Improve Communication

Communication difficulties are the primary reason taxpayer claims do not meet initial qualifications. The IRS should continue to work to improve communication with taxpayers by improving forms, publications, instructions, process and procedures, as follows.

- **Revise Form 8857, Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief).** Taxpayers seem to have great difficulty determining which year to include on the form. Instructions included with Form 8857 should include examples and step by step instructions showing taxpayers which year(s) they should include and how to determine which years may be eligible for relief. We further recommend that the Innocent Spouse Task Force consult with representatives of taxpayers who file and prepare Form 8857, particularly Low Income Taxpayer Clinic staff and volunteers, who are very familiar with the difficulty that low income taxpayers have in navigating the tax system and who are very experienced in effectively communicating with their client base.
- **Create a Toll-Free Phone Number.** The IRS should implement the Innocent Spouse Task Force's recommendation to create a special toll-free number for taxpayers to contact the IRS with innocent spouse questions. The number should also be included on the Form 8857 as a resource for assisting taxpayers in determining the correct year to include. For taxpayers calling about a pending request for relief, whenever possible, the call should be routed to the CCISO employee who is working to make a determination on their case.
- **Implement Innocent Spouse Task Force Recommendations.** The National Taxpayer Advocate applauds the IRS's decision to create the Innocent Spouse Task Force to recommend ways to improve communications with taxpayers and practitioners. We recommend the IRS seriously consider all of its recommendations and suggest the task force consult with representatives of taxpayers.

- **Inform Taxpayers of their Right to Seek Relief.** The IRS did not inform taxpayers whose claims were erroneously denied as untimely that it will now consider their claims timely as a result of the 2004 holding in *McGee v. Commissioner.* The IRS knows about 6,000 such claims were involved and could determine who submitted them. The IRS should send these taxpayers a letter to inform them the IRS would now consider their claims on the merits.
- **Outreach and Education.** When the IRS implements changes to the Innocent Spouse program, such as those recommended by the National Taxpayer Advocate, it should communicate such changes to taxpayers through targeted outreach and education efforts.

Improve Policies and Procedures

- **Date Stamping Form 8857.** Campus processing procedures for IRS employees who open mail should make clear that they need to date stamp Form 8857 upon receipt. These employees rely on IRM § 3.10.72, which includes a list of correspondence that requires a date stamp. This list does not include Form 8857.[73] Specifically, the IRS should revise IRM § 3.10.72 so the appropriate employees are aware of the date stamping requirement.
- **Reconsideration Process.** The IRS should reconsider innocent spouse determinations when taxpayers provide new information, just as it reconsiders all other liability determinations pursuant to its audit reconsideration process when taxpayers provide new information. In its response, the IRS notes, "the statute does not permit the IRS to apply the same audit reconsideration procedures to innocent spouse claims as it uses for audit deficiency assessments." The IRS may be focusing on the fact that the Code expressly authorizes the IRS to rescind a notice of deficiency with the taxpayer's consent, but does not expressly authorize the IRS to rescind a final determination under the innocent spouse rules.[74] To be clear, however, we do not suggest that the IRS should rescind a final determination, but rather that the IRS reconsider relief when appropriate after a final determination has been made. The Code does not prohibit such a procedure, and the IRS should implement it without delay.[75]

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73 *Compare* IRM § 25.15.2.4 (May 1, 2005) (including instructions for date stamping Form 8857 in an IRM entitled "Relief from Joint And Several Liability - General Procedures / Employees with Taxpayer Contact") *with* IRM § 3.10.72 (Jan. 1, 2005)(including instructions for stamping received dates on many forms/documents, **but not Form 8857** in a IRM entitled "Campus Mail and Work Control – Extracting, Sorting, and Numbering").

74 *Compare* IRC § 6212(d) *with* IRC § 6015.

75 Indeed, the Code expressly gives the IRS the authority to abate tax that is "excessive" or "erroneous." *See* IRC § 6404(a).

PROBLEMS

Reduce Processing Time

The National Taxpayer Advocate recognizes and supports the recent progress that both CCISO and Appeals have made in reducing processing time. However, the IRS needs to work towards reducing processing time even further, as follows.

- **Reconcile Inconsistent Computer Systems.** The IRS should continue its initiative to reconcile the differences between ISTS and ACDS. Once it has good consistent cycle time data, management will be better able to detect the real source of any delays.
- **Study Ways To Further Reduce Processing Time.** The IRS should sponsor research to determine how it can reduce the time a given taxpayer has to wait for determinations by Compliance and/or Appeals. In researching this issue, the IRS should conduct interviews and focus groups with taxpayer representatives, including Low Income Taxpayer Clinics, as well as taxpayers, to determine what are the sources of delays and confusion from the perspective of taxpayers and their representatives.

PROBLEM

TOPIC #20 MOST SERIOUS PROBLEM: LIMITATIONS OF COLLECTION ACCOUNT DATABASES

RESPONSIBLE OFFICIALS

Kevin M. Brown, Commissioner, Small Business/Self-Employed Division

Richard Morgante, Commissioner, Wage & Investment Division

David B. Robison, Chief, Appeals

W. Todd Grams, Chief Information Officer, Modernization & Information Technology Services

DEFINITION OF PROBLEM

When a taxpayer contacts the Internal Revenue Service about a collection issue, the taxpayer's entire account history is not accessible on one central computer system. Instead, the IRS maintains collection-related account histories on several systems, depending on the issue. The lack of access to full histories in one place makes it difficult for IRS contact employees to respond to taxpayers' questions or provide proper guidance on potential case resolutions. This inaccessibility often leads taxpayers to seek the assistance of the Taxpayer Advocate Service.

The IRS has addressed the need to centralize account information by implementing Desktop Integration (DI), which the IRS plans to fully deploy by January 2006 to replace the Integrated Case Processing system (ICP). As its name implies, DI integrates various IRS computer systems, making it easier for employees to document taxpayer contact and access account information when responding to taxpayer inquiries and working compliance issues.[1] However, it is our understanding that Accounts Management in Wage & Investment's Customer Account Services (CAS AM) has requested to exempt its employees from the requirement to use DI.[2] This exemption would be a great disservice to taxpayers who call the IRS and cannot get a response because the contact employee in Accounts Management does not have access to the information.

Further, the rollout of the Customer Account Data Engine (CADE) through 2012 will enhance customer service by ensuring that account histories include the most current information. While it is understandable that this transition is a monumental task, the IRS must make every effort to implement the program in the most expeditious manner possible.

[1] Desktop Integration Overview, *Desktop Integration Manager's Tool Kit*.

[2] A Letter of Understanding (LOU) between the IRS and the National Treasury Employees Union (NTEU) made use of DI mandatory for several organizations within the IRS. Letter of Understanding (Feb. 23, 2005). SB/SE Response to TAS Information Request (July 11, 2005).

ANALYSIS OF PROBLEM

Background: IRS Computer Systems

The IRS keeps taxpayers' account histories regarding collection activities on one or more of the following computer systems:

- **Automated Collection System (ACS).** ACS maintains balance due accounts and return delinquency investigations, and systemically posts all collection actions to the Master File.[3] Only specifically designated employees can alter information on the system. ACS call site officials will grant specific permission to individual employees in other IRS functions, such as the Taxpayer Advocate Service, to gain full rights to the system. Read-only access is also available to Integrated Case Processing (ICP) users.[4] Due to space limitations related to the integration of ACS with ICP, comments on ACS were difficult to decipher, especially for non-ACS employees. One such example of an ACS comment is the following:

  > 03052004 TPPI, DV,IDSLF,TP CL8S LVY ON SSA, TP UNDR BNKRPCY SNC DEC 2003, LVY PYS ADJST BY INSLVNCY UNT SNC DEC 2003 AFTR BNKRPCY FLD, GV TP TEL OF BNKRPCY 4 INQRYS. ADV TP CSE CTRLD & MST CL INSLV 4 ANY ?, TP CL8S NVR RCVD F843, PR IDRS FRM XSGND ADV SND AGAIN.[5]

  Read-only permission is not useful for non-ACS employees if the comments are indecipherable abbreviations such as the above. However, the integration of ACS with Desktop Integration (DI) should resolve this issue by allowing more space for comments in plain English.[6] DI users are granted read-only permissions to ACS. ACS histories are archived for two years once the cases are closed.[7]

- **Automated Lien System (ALS).** The Automated Collection System (ACS) and

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[3] IRM § 5.19.5.2. SB/SE Response to TAS Information Request (July 14, 2005). The Master File is comprised of the Individual Master File (IMF) for individual taxpayers, the Business Master File (BMF) for business taxpayers, and the Nonmaster File for cases that do not fit into either of the other two categories. The IMF receives individual tax submissions in electronic format and processes them through a pre-posting phase, posts the transactions, analyzes the transactions and produces output in the form of Refund data, Notice data, Reports, and information feeds to other entities. IRS, Individual Master File, at http://www.irs.gov/privacy/article/0,,id=130971,00.html. BMF receives all tax data and related information pertaining to individual business income taxpayers. BMF posts transactions so that the file reflects a continuously updated and current record of each taxpayer's account. IRS, Business Master File, at http://www.irs.gov/privacy/article/0,,id=130752,00.html.

[4] ICP, which is scheduled to go out of service by December 31, 2005, is discussed in more detail below. Desktop Integration (DI), also discussed in detail below, will replace ICP.

[5] Statement from ACS History Narratives on a taxpayer's account accessed through ICP.

[6] It is important that ACS properly train its employees regarding the new space parameters with the advent of DI. Otherwise, ACS employees will continue to use the indecipherable code required in ICP.

[7] SB/SE Response to TAS Information Request (July 14, 2005).

the Integrated Collection System (ICS) transmit requests to ALS to generate liens.[8] ALS tracks lien assignments and due dates, generates Notices of Federal Tax Liens (NFTLs) and Releases of Liens, and supports management information reports.[9] ALS updates the master file to indicate that an NFTL has been filed.[10] Data is deleted from ALS one year after the lien is satisfied or released.[11] Access to ALS is limited, but the Small Business/ Self-Employed Operating Division (SB/SE) expanded access to the program in 2004 to allow IRS employees with legitimate reasons for access to the system to release notices of liens.[12]

- **Integrated Collection System (ICS).** ICS provides workload management, case assignment tracking, inventory control, electronic mail, case analysis tools, and Management Information System (MIS) capabilities to support SB/SE collection fieldwork.[13] Other IRS employees with a business need may have read-only access.[14] ICS is downloaded each night to the Integrated Data Retrieval System (IDRS)[15] and vice versa. After IDRS confirms closure, the case remains on ICS for six months and is subsequently archived for three years. Although ICS is compatible with Desktop Integration (DI), access to DI does not grant read-only access to ICS. Further, ICS does not interact with the Appeals Centralized Database System (ACDS) or Collection Due Process Tracking System (CDPTS).[16]
- **Appeals Centralized Database System (ACDS).** The ACDS database combines

8 IRS, Automated Lien System, at http://www.irs.gov/privacy/article/0,,id=130731,00.html (last visited Oct. 4, 2005).

9 When an employee requests the filing of an NFTL from either the Integrated Collection System (ICS) or ACS, it is transferred to the ALS. Treasury Inspector General for Tax Administration, Ref. No. 2004-30-086, *Fiscal Year 2004 Statutory Review of Compliance With Lien Due Process Procedures* 18 (April 2004). For a discussion on the issues surrounding the delays in processing exception reports for liens that fail to post of Master File or ALS and lien releases that require manual penalty and interest computations (restricted interest), see Government Accountability Office, GAO-05-26R, *Opportunities to Improve Timeliness of IRS Lien Releases* (Jan 10, 2005).

10 Treasury Inspector General for Tax Administration, Ref. No. 2004-30-086, *Fiscal Year 2004 Statutory Review of Compliance With Lien Due Process Procedures* 15 (April 2004).

11 IRM § 1.15.35.

12 IRM § 5.12.6.2.1(1). Treasury Inspector General for Tax Administration, Ref. No. 2004-30-086, *Fiscal Year 2004 Statutory Review of Compliance With Lien Due Process Procedures*, 18 (April 2004).

13 SB/SE Collections, W&I Field Assistance have access to ICS. SB/SE Response to TAS Information Request (Sept.16, 2005). There are two types of histories on ICS: System Generated and User-Created. Appeals employees working Collection Due Process (CDP) cases manually update ICS histories. IRM § 8.7.2.3.12.

14 Appeals, TAS, Chief Counsel Campus Centralized Case Processing and miscellaneous employees may have read-only access to ICS. SB/SE Response to TAS Information Request (Sept.16, 2005).

15 Integrated Data Retrieval System (IDRS) is a general term used within IRS to refer to Real Time processing that uses various Command Codes, and daily, weekly and periodic support processing for the various IRS systems. IRS, Integrated Data Retrieval System (IDRS), at http://www.irs.gov/privacy/article/0,,id=131489,00.html (last visited on Oct.19, 2005).

16 IRM § 1.15.35. SB/SE Response to TAS Information Request (Sept.16, 2005).

all the various standalone databases in Appeals into one centralized system.[17] Appeals employees use the application to track case receipts, record case time, document case actions, and monitor the progress of the organization's workload. Only Appeals employees can access this database. ACDS does not transmit data to other taxpayer account databases, but receives data from Automated Offer in Compromise (AOIC) and Examination Return Control System (ERCS) on cases identified as bound for Appeals.[18]

- **Automated Offer In Compromise (AOIC)** – AOIC allows the user to process, view, and track the status of each offer in compromise (OIC), and also generates forms, letters, and managerial reports.[19] After the IRS accepts an OIC, AOIC automatically places an indicator code on the taxpayer's Individual Master File (IMF) account to ensure that collection activity is suspended and all subsequent tax returns are filed and paid timely during a five-year compliance period.[20] Every case worked on the AOIC since 1994 is still on the active database.[21] AOIC systematically uploads to Integrated Data Retrieval System (IDRS),[22] but is not integrated with DI.[23] Any function can have access to the program, but will receive read-only permissions if the function's employees do not work OIC cases.[24]
- **Collection Due Process Tracking System (CDPTS).** CDPTS tracks the progress and location of CDP hearing requests and notices of determination. While the system tracks similar CDP-related information to ACDS, it is available to authorized employees in various functions such as Wage & Investment ACS, SB/SE ACS and Field functions, TAS, and the Office of Appeals. As a case is processed, CDPTS is updated to reflect its status, and histories are maintained on the Integrated Data Retrieval System (IDRS) indefinitely.[25]
- **Taxpayer Advocate Management Information System (TAMIS).** TAMIS is the Taxpayer Advocate Service (TAS) database that records and tracks TAS activity and case advocate performance in assisting taxpayers experiencing problems and/or

17 IRM § 8.20.2.2.6. Appeals has information relevant to collection because among the responsibilities of the organization are Collection Due Process (CDP) hearings, the Collection Appeals Program (CAP), offers-in-compromise, and jeopardy levies. IRM § 8.1.1.2(2).

18 IRS, Appeals Centralized Database System, at http://www.irs.gov/privacy/article/0,,id=135314,00.html. It is unclear how long cases stay on ACDS before being archived or deleted.

19 Treasury Inspector General for Tax Administration, Ref. No. 2003-30-182, *Continued Progress Is Needed to Improve the Centralized Offer in Compromise Program* 26 (Sept. 2003).

20 Treasury Inspector General for Tax Administration, Ref. No. 2004-30-043, *Monitoring of Accepted Offers in Compromise Is Generally Effective, but Some Improvement Is Needed* 5 (Jan. 2004).

21 IRM § 1.15.35.

22 IRM § 5.8.3.

23 The IRS plans to make AOIC available through DI. SB/SE Response to TAS Information Request (Sept. 12, 2005).

24 Examples of functions with current access to AOIC include Collection, TAS, Exam, Appeals, Help Desk and TEGE. SB/SE Response to TAS Information Request (Sept. 12, 2005).

25 SB/SE Response to TAS Information Request (Sept. 13, 2005).

hardships with the IRS. Access to the database is strictly limited to authorized TAS employees. However, TAS grants limited access to TAMIS to certain employees in the operating divisions who have a business purpose for accessing the database, such as National Taxpayer Advocate Toll-Free Assistors and Liaisons to TAS. TAMIS account histories are not available to the rest of the IRS.[26]

Integration of Systems

The IRS has made strides in integrating various account history databases. The Integrated Case Processing System (ICP) initially served this role in a limited capacity but is scheduled for replacement by December 31, 2005. Desktop Integration (DI) will replace ICP with enhanced capabilities.

INTEGRATED CASE PROCESSING (ICP)

ICP provides access to multiple systems from a single workstation through a user-friendly interface and display of taxpayer account information.[27] ICP may delete account history on accounts that are inactive for at least 13 months.[28] ICP is a cross-functional system that IRS employees[29] use for the following tasks: [30]

26 IRM §§ 13.4.1, 13.4.3.2. IRC § 7804(c)(4)(A)(iv) states TAS may at the discretion of the local Taxpayer Advocate, not disclose to the IRS contact with, or information provided by, such taxpayer. The TAMIS System Administrator and Database Administrator ensure that only authorized personnel are allowed access to the TAMIS database for query, update and report generation. Internal Revenue Manual § 13.4.2.3.1(2).

27 The multiple systems include: Centralized Inventory Distribution System (CIDS), Servicewide Electronic Research Project (SERP), and Automated Non-Master file (ANMF). SB/SE Response to TAS Information Request (July 11, 2005).Treasury Inspector General For Tax Administration, Ref. No. 2005-20-097 *Managers and System Administrators Need to Limit Employees' Access to Computer Systems* (July 2005); IRS, Contact Recording for Taxpayer Assistance Centers (TAC), at http://www.irs.gov/privacy/article/0,,id=131943,00.html; Integrated Case Processing (ICP) Website, http://www.icp.swr.irs.gov/.

28 Once an account history is deleted on ICP, it is no longer accessible. SB/SE Response to TAS Information Request (July 11, 2005).

29 Employees in the following organizations have access to ICP: Customer Account Services (CAS) Accounts Management (AM)/Submission Processing (SP), CARE Field Assistance, Compliance ACS/Compliance Services Collections Operations/ACS Support, TAS, Appeals (Customer Service Officers only). While those are the primary user groups, there are a few employees in Tax Exempt and Government Entities (TEGE), CIB, Automated Underreporter (AUR), EXAM, Disclosure and other miscellaneous groups with limited access. SB/SE Response to TAS Information Request (July 11, 2005).

30 W&I Accounts Management (AM) and Customer Assistance, Relationships and Education (CARE) use ICP for access to s-4442, an on-line Inquiry Referral (Form 4442), and e-911, an electronic version of the Application for Taxpayer Assistance Order (Form 911) that is automatically loaded into TAMIS. AM SB also uses ICP to work Electronic Account Resolution inquiries from practitioners received through E-Services. ACS users used ICP to issue manual levy releases and some left ACS comment history on ICP which was systemically transferred over to ACS (ACS users now have access to DI and ACSWeb). TAS has access to ICP. Any Form 911, Application for Taxpayer Assistance Order, created by an IRS employee must be loaded onto ICP (after managerial review). SB/SE Response to TAS Information Request (July 11, 2005); Attachment 1, John J. Mannion, TAS Implementation of the Integrated Case Processing (ICP) System (Aug. 28, 2003).

- Highlight key processing events that may be in progress;[31]
- Provide a case selection tool to bring the account up on ICP, IDRS and ACS (if ACS user);
- Allow employees to review universal history and information from other functions such as Automated Underreporter (AUR) and Automated Non-Master File (ANMF);
- Provide access to a common set of tools such as worksheets, forms, calendar functions and templates (for letters and IDRS commands); and
- Access the Reasonable Cause Assistant (RCA).[32]

DESKTOP INTEGRATION (DI)

DI is scheduled to replace ICP in 2006 and improve on ICP by providing "one stop" customer service. DI users will, through a single computer system and terminal, be able to capture, manage, and respond to taxpayers' questions by interfacing with multiple IRS systems. The new system is designed to complement and not replace existing account databases.[33]

Like ICP, DI is a cross-functional application.[34] In addition to ICP capabilities, DI will provide:[35]

- An open and accessible single repository for taxpayer account case histories, which it will systemically acquire from a collection of designated systems;
- An inventory and workflow system that serves multiple operating divisions;

[31] This feature is useful for Customer Service Representatives who need to respond to taxpayer inquiries. Customer Service Representatives have a variety of responsibilities. Most of their time is spent assisting taxpayers on the telephone, working paper cases or assisting taxpayers at Taxpayer Assistance Centers. IRM § 21.1.1.6; How Does it Work, Desktop Integration Manager's Tool Kit.

[32] RCA is a used to assist in the determination of penalty abatements on the basis of reasonable cause. SB/SE Response to TAS Information Request (July 11, 2005).

[33] Desktop Integration Manager's Tool Kit, Desktop Integration Talking Points. The system enables access to Electronic Automated Collection Service Guide (e-ACSG), Electronic Accounts Resolution Guide (e-ARG), Report Generation Software (RGS), and Correspondence Imaging System (CIS) and interfaces with Integrated Data Retrieval System (IDRS) / Corporate Files On Line (CFOL), Automated Collection System (ACS), Correspondence Examination Automation Support (CEAS), Automated Underreporter (AUR), Automated Non-Master File (ANMF), Integrated Collection System (ICS). IRS, Desktop Integration, at http://www.irs.gov/privacy/article/0,,id=130913,00.html; IRS, W&I, *FY 2007 Strategic Assessment* 27 (February 2, 2005) PowerPoint Presentation, *Welcome to Desktop Integration: Overview for Employees* (Sept. 22, 2004).

[34] Primary users of DI include CAS Accounts Management (AM)/Submission Processing (SP), CARE Field Assistance, Compliance ACS/Compliance Services Collections Operations/ACS Support, TAS, and Appeals (only Customer Service Officers, but Appeals has requested access to all Appeals employees). In addition, some employees in Tax Exempt / Governmental Entities (TEGE), Criminal Investigation (CI), Automated Underreporter (AUR), EXAM, Disclosure and other miscellaneous groups have limited access. TEGE and Appeals have requested access to DI for all employees. SB/SE Response to TAS Information Request (July 11, 2005).

[35] Desktop Integration Manager's Tool Kit, Desktop Integration Talking Points.

- A universal set of common tax processing tools to complement existing corporate accounting systems;[36] and
- A history that cannot be edited or deleted (unlike ICP).[37]

Customer Account Data Engine (CADE)

The age and complexity of the Individual Master File (IMF) system cause delays and inaccuracies in taxpayer service. The IRS updates IMF files weekly, which results in non-synchronized databases with inconsistent and incorrect data reporting to taxpayers. The IRS plans to replace IMF and the Business Master File (BMF) through gradual implementation of the Customer Account Data Engine (CADE), which will significantly decrease the time needed for processing and posting information to taxpayers' accounts. The incremental release of CADE began in July 2004 with limited Form 1040EZ returns, and is scheduled to continue through 2012 with each successive release moving increasingly complex returns onto the system. The implementation of CADE benefits taxpayer service by increasing the speed of return and refund processing, and providing employees who work taxpayer inquiries with information that is more up to date.[38]

Problems with Collection Account Information Systems

Lack of Access to Entire Account History.

Collection information from taxpayers' accounts may be spread across several IRS computer systems. Without access to all of them, IRS employees have trouble answering taxpayers' collection inquiries and may be unable to provide proper guidance to resolve taxpayers' issues. Taxpayers who are already dealing with a stressful collection experience face the added frustration of making several phone calls or needing to talk to several employees before getting an answer.

From September 1, 2004 through August 31, 2005, TAS received 7,648 case referrals from operating divisions involving Collection and Appeals issues. A review of a random sample of 478 cases showed that 77 percent had account histories on three or more IRS applications.[39]

Potential for Errors

The multiplicity of systems and lack of automatic postings from one system to another create the potential for errors or inconsistencies. For example, an IRS function responsible for maintaining a certain database might fail to properly update another system.

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36 IRS/NTEU Letter of Understanding (March 16, 2005).

37 The DI history retention requirements are not final at the time of this draft.

38 Customer Account Data Engine (CADE) Overview, Pre-filing Season Conference, CERCA/NACTP (Sept. 8, 2005).

39 Listed in descending order, the applications identified most during the review were the following: IDRS, ICP, ACS, ALS, ICS, ACDS, AOIC, AIS, and miscellaneous systems (AUR, RGS, CDPTS).

Implementation of DI

Desktop Integration (DI) will provide IRS employees with greater access to systems that contain the information they need to respond to taxpayers' inquiries. However, the possible exemption of W&I CAS Accounts Management employees from the mandate to use DI raises serious concerns. A lack of access will deny AM employees the cross-functional information necessary to respond effectively and efficiently to taxpayers, which means their inquiries may require a referral or callback.[40]

Further, while DI will provide access to many systems, it will not let employees view several important collection databases. For example:

- Access to DI does not grant read-only access to ICS even though ICS is compatible with DI. Read-only access is available to employees, but they must formally request it and demonstrate a business reason to view the account.[41]
- AOIC systematically uploads to IDRS but is not integrated with DI.[42] Therefore, IRS contact employees who receive taxpayer inquiries regarding an offer in compromise cannot provide details about the OIC if they do not have read-only permission on the AOIC.
- ACDS is available only to Appeals employees and does not transmit data to other IRS taxpayer account databases.[43]

Insufficient IDRS Detail

Many systems that are not integrated with DI do not upload sufficient detail to the Integrated Data Retrieval System (IDRS).[44] The resulting insufficient detail on IDRS prevents contact employees from giving complete and accurate information to taxpayers if the employees also lack access to the source databases. A few examples of this issue include the following:

- **IDRS Codes for CAP Appeals:** IDRS does not have transaction codes to reflect the history of cases appealed through the Collection Appeals Program (CAP), nor do IDRS users have information regarding the outcome of past appeals or the status of current requests.[45]

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[40] SB/SE Response to TAS Information Request (July 11, 2005); IRS/NTEU Letter of Understanding (March 16, 2005). Use of the system will be mandatory for employees in the following organizations: Automated Collection System (ACS), Automated Collection System Support (ACSS), Compliance Services Collection Operations (CSCO), CARE, and TAS. Unfortunately, CAS AM has decided to petition to exempt AM employees from the requirement to use DI.

[41] SB/SE Response to TAS Information Request (Sept.16, 2005).

[42] IRM § 5.8.3. The IRS plans to make AOIC available through DI. Further, any function can request read-only permission to AOIC. SB/SE Response to TAS Information Request (Sept. 12, 2005).

[43] IRS, Appeals Centralized Database System, at http://www.irs.gov/privacy/article/0,,id=135314,00.html.

[44] Systems that systematically upload to IDRS but are not integrated with DI include ALS, AOIC, CDPTS, and ICS.

[45] IRS Employee Suggestion Program No. 20-03-04-033 (Submitted Sept. 17, 2004).

- **IDRS and Installment Agreement Designated Payment Codes.** IDRS does not distinguish between voluntary payments and payments made pursuant to an Installment Agreement. This lack of distinction results in disagreements over the posting of payments and confusion by the IRS contact employee over which payment application applies.[46]
- **IDRS and Defined Seizure Designated Payment Codes.** When the IRS receives proceeds from a seizure or sale, IDRS does not indicate which asset generated the payment. This information is on ICS, but is archived after six months.[47]
- **IDRS and User Fees.** User fees for offer in compromise, installment agreements, and photocopies of returns are not posted to the taxpayers' accounts on IDRS. They are posted into accounts set up by the Revenue Accounting Control System (RACS) unit in Accounting, but contact employees, including TAS case advocates, cannot access the systems that show these payments.[48]

IMPLEMENTATION OF CADE

CADE substantially improves the integrity of account histories by ensuring that the most current information is available and accessible to IRS employees.[49] Taxpayers expect and deserve some level of sophistication from the IRS, and it is unacceptable if the IRS gives taxpayers dated information on their account status through either direct contact or notices. The IRS should make all efforts to fully implement this system in an expeditious manner.

IRS COMMENTS

The IRS is fully aware of the limitations of its various collection account databases and their impact on both taxpayers and employees. As noted below, the IRS is constantly pursuing ways to make the systems more effective and efficient within existing budget constraints.

Desktop Integration and Universal Case History

The IRS is committed to improving customer service by creating a Universal Case History. We will propose the Universal Case History project for consideration as an IT improvement project in FY 2006.

The Universal Case History would be housed in a central location so that, when a taxpayer contacts the IRS about a collection issue, relevant account history is available to

[46] IRS Employee Suggestion Program No. 20-03-05-004 (Submitted Oct. 5, 2004).

[47] IRS Employee Suggestion Program No. 20-03-05-006 (Project Closed as Non-Adopt) (Submitted Oct. 6, 2004).

[48] SAMS Submission I0004571 received February 24, 2005 (issue referred to TAS Taxpayer Account Operations).

[49] Customer Account Data Engine (CADE) Overview, Pre-filing Season Conference, CERCA/NACTP (Sept. 8, 2005); MITS Fact Sheet, Customer Account Data Engine (CADE).

respond to the issue appropriately, while minimizing the need to access multiple systems. Desktop Integration (DI) has the capability today to accept history entries from other IRS systems and does in some cases (ACS and Correspondence Imaging System (CIS)). The IRS is planning to expand this with the Universal Case History.

In 2006, Integrated Collection System (ICS) users will have access to DI and therefore will have access to case history input by ACS and the Campuses. It will take further DI enhancements in the future to interface ICS with DI to add history. We currently are identifying the necessary specific enhancements and plan to include them in the Universal Case History proposal. In addition, we also will enhance the systems to extract information from the Automated Lien System (ALS), Automated Offer in Compromise System (AOIC), Automated Insolvency System (AIS), and other systems to secure account resolution codes. The project will attempt to leverage and enhance document imaging capabilities to associate documents, such as written correspondence, with the accounts.

CAS and Desktop Integration

The Wage and Investment Division's Customer Accounts Services (CAS) organization did not request to exempt its employees from the requirement to use DI to lower the quality of service it provides to taxpayers. Rather, CAS determined that, in order to best assist taxpayers, its employees will continue to need to access a variety of applications that currently are not programmed into DI, such as CIS. The Wage & Investment Division advised CAS employees that they are not required to use DI, but should use it to complement work on the other systems and applications in instances where DI will improve efficiency. For example, DI will provide some automated forms, letters, and worksheets that are not available on CIS. Currently, 10,535 CAS employees have access to DI and that number should increase to well over 16,000 by the end of December 2005.[50] Employee training materials are incorporating the appropriate usage of DI and other systems.

Appeals Centralized Database System (ACDS)

Appeals employees use the Appeals Centralized Database System (ACDS) and up to 17 other IRS systems. The ACDS is Appeals' inventory system, but does not combine Appeals' standalone databases into one centralized system. Appeals has completed a "Concept of Operations" analysis and intends to create "interoperability" between the ACDS and the other approximately 17 systems, which will mean that, when Appeals closes a case with certain recommended actions, automatic or systemic changes to other databases, including IDRS, will be made. Further, Appeals employees will become users of DI during FY 2006.

50 As of November 2005, DI users are as follows: 3,632 ACS, 10,535 CAS, 1,788 CARE, 2,582 CSCO, 1,501 TAS, 42 AUR, and 249 Exam. Beginning in March 2006, 300 TEGE users and 1,900 Appeals users will be added.

In July 2005, programming was completed to produce validation reports comparing CDPTS and ACDS to improve the consistency and reliability of data and inventory on both systems. Appeals and SBSE are using these reports cross-functionally and believe they will produce benefits for taxpayers.

Additionally, Appeals is developing better case resolution data to allow the Operating Divisions greater insight into how Appeals' employees resolve cases. The new procedure will allow Appeals to identify the number of cases denied in full or in part and the underlying reasons for resolution. The automated closing document will also contain instructions for the Appeals Processing Section to accurately and timely update all systems, including ACDS, ISTS and IDRS. Implementation of this new procedure should occur in FY 2006.

Finally, the IRS agrees with TAS' comment that IDRS currently does not have transaction codes to show the history of cases appealed through CAP, and IDRS users do not have information regarding the outcome of the past appeals or the status of current requests. This type of information would be useful in understanding taxpayer case resolution and history. As a result, Appeals will include this recommendation in our "interoperability" requirements mentioned earlier.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate is pleased that the IRS is working to improve customer service by designing the Universal Case History (UCH), thereby addressing the limitations of its collections account databases. We encourage the IRS to move forward as quickly as possible with the development and implementation of this system. We also urge Congress to ensure that the system is adequately funded.

The IRS comments state that Desktop Integration (DI) has the current capability to accept history entries from other systems. Future enhancements could interface the Integrated Collection System (ICS) with DI to add history and extract information from Automated Levy System (ALS), Automated Offer in Compromise System (AOIC), Automated Insolvency System (AIS), and other systems. However, it is unclear whether these enhancements are included in the yet to be proposed UCH. Regardless, the National Taxpayer Advocate recommends incorporating these systems into DI as soon as possible.

The IRS also indicated that Wage & Investment (W&I) advised Customer Account Services (CAS) employees that they are not required to use DI. CAS employees are instructed to use DI to complement the other applications to improve efficiency. Although the IRS did not to intend to harm taxpayers by taking this approach, we believe that advising CAS employees that they are not required to use DI will have a harmful effect on taxpayers. It is unclear why the IRS cannot instruct CAS employees that they are required to use DI and complement such access through the use of other applications not programmed into DI. While it is encouraging that the number of DI users has increased, it is important that all CAS employees are given access to DI and instructed to use the system when it will best serve the customer. While increasing efficiency is certainly a valid reason to access the system, employees should use DI when they believe access to the system would enable them to provide complete and accurate answers to the customers' questions in the most expeditious manner possible.

We are pleased that Appeals intends to interface the Appeals Centralized Database System (ACDS) with other systems and databases, including IDRS. However, it is unclear when this "interoperability" will be implemented or why the decision was made to not interface the various Appeals systems with DI. Interfacing with DI would allow all DI users access to data on the status of current appealed cases and eliminate the need for the Appeals Processing Section to update various systems upon the resolution of cases.

Finally, the IRS agreed with our recommendation to include CAP (Collection Appeals Program) transaction codes in IDRS in their interoperability requirements. However, the IRS response does not address the need to integrate the systems to allow for the inclusion of designated payment codes in IDRS for installment agreements, defined seizures, and user fees.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

- Make every effort to secure proper funding of the Universal Case History initiative and expedite the development and implementation of the system.
- Expedite the enhancement of Desktop Integration (DI) to interface the Integrated Collection System (ICS) with DI to add history and extract information from Automated Levy System (ALS), Automated Offer in Compromise System (AOIC), Automated Insolvency System (AIS), and other systems.
- Review whether customers would be best served if W&I CAS employees were required to use DI and complement such access through the use of other applications not programmed into the system.
- Review the feasibility of interfacing the various Appeals systems with DI.
- Integrate the systems to allow IDRS to provide sufficient details on cases appealed through CAP and on designated payment codes for installment agreements, defined seizures, and user fees.
- Make all efforts to fully implement the Customer Account Data Engine (CADE) in an expeditious manner.

PROBLEM

TOPIC #21 MOST SERIOUS PROBLEM: REASONABLE CAUSE ASSISTANT

RESPONSIBLE OFFICIALS

Mark E. Matthews, Deputy Commissioner, Services and Enforcement
Richard J. Morgante, Commissioner, Wage and Investment Division
Kevin M. Brown, Commissioner, Small Business/Self-Employed Division
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DEFINITION OF PROBLEM

The IRS developed the Reasonable Cause Assistant (RCA) program, a computer-based decision support tool, to increase consistency in the administration of penalty relief. While the program is certainly beneficial, the IRS does not use RCA for all reasonable cause determinations. In addition, the high rate of RCA abatement conclusions indicates that the IRS needs to eliminate unnecessary penalty assessments. Further, because the Office of Appeals does not break down penalty appeals data to differentiate RCA cases from non-RCA cases, the IRS cannot effectively analyze the penalty systems in place, including RCA, to ensure they operate effectively and efficiently.

It is unclear whether RCA provides enough flexibility for the user to take into account extenuating circumstances. The low rate at which RCA users abort the program's conclusions may indicate that RCA does not encourage users to override an RCA decision even when appropriate.

ANALYSIS OF PROBLEM

Background

The Reasonable Cause Assistant (RCA) is a decision support system designed to help IRS employees make relief determinations based upon reasonable cause for the following penalties:[1]

- Failure to File (FTF) for individual taxpayers (IRC § 6651);
- Failure to Pay (FTP) for individual taxpayers (IRC § 6651); and
- Failure to Deposit (FTD) for business taxpayers (IRC § 6656).

The use of RCA became mandatory on January 1, 2002, for all IRS employees who make reasonable cause determinations.[2] Over 20,000 employees are profiled to use RCA through the Integrated Case Processing (ICP) or Desktop Integration (DI) systems. Users include Customer Service Representatives and Tax Examiners. Revenue Officers,

[1] RCA is a component of the Integrated Case Processing system (ICP). IRM § 20.1.1.3.5.

[2] IRS, Alert No. 306, *Reasonable Cause Assistant (RCA) Information* (Dec. 28, 2001); IRM § 21.3.4.3.10.4. However, IRS employees who make reasonable cause determinations but have no access to ICP, such as Revenue Officers and Revenue Agents, do not use RCA for their abatement determinations. Office of Penalty and Interest Administration Response to TAS Information Request (Oct.11, 2005).

Revenue Agents, and Tax Auditors do not use RCA because they lack access to ICP, but they may use RCA in the future through Desktop Integration.[3]

The majority of front-line employees who make penalty relief determinations receive RCA training as part of their computer-based Continuing Professional Education, and use the RCA Desk Reference Guide.[4] The RCA program takes into consideration the following taxpayer-specific facts and circumstances to determine whether to grant penalty relief:[5]

1. History of compliance and no FTF, FTP or FTD penalties assessed within the prior three years ("First Time Abatement");
2. Unavoidable absence of the taxpayer;[6]
3. IRS error;
4. Bankruptcy of the taxpayer;
5. Death, illness or impairment of the taxpayer, a relative, or person affecting the taxpayer's business;
6. Divorce affecting compliance;
7. Elderly age or incapacity of the taxpayer;
8. Mail problems;
9. Mitigating circumstances;
10. Unobtainable records;
11. Relocation of the taxpayer; and
12. Missing taxpayer signature on the tax return.

The IRS developed the program to ensure that all functions administer penalty relief consideration consistently.[7] By designing a more equitable system, the IRS aimed to encourage voluntary compliance[8] and increase efficiency by providing the following features:

- **Account analysis for the "first time abatement" of penalties.** The analysis considers information on return due dates and received dates, compliance history (RCA

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[3] Office of Penalty and Interest Administration Response to TAS Information Request (Oct. 11,, 2005).

[4] Attachment, Benefits of Using Reasonable Cause Assistant, Memorandum from the Director of Compliance Policy, Increased Oral Testimony Threshold for Granting Penalty Relief.

[5] IRS Training, Introduction to ICPNT, Unit 7, Lesson 1, Screen 16.

[6] IRM § 20.1.1.3.1.2.4 states "death, serious illness or unavoidable absence of the taxpayer may establish reasonable cause for late filing, payment, or deposit." In this context, unavoidable absence could include a necessary business trip outside of the country or other absences which would prevent compliance.

[7] IRM § 21.3.4.3.10(4).

[8] IRM § 20.1.1.3.5. Before the launch of RCA, the IRS experienced inconsistencies among IRS functions regarding attitudes toward and procedures for reasonable cause abatements. IRS Training, Introduction to ICPNT, Unit 7, Lesson 1, Screen 3.

calculates the timeframes to determine compliance), and types and amounts of penalties;

- **"Reason Statements."** The system provides "reason statements" that the IRS employee can use to explain the result to the taxpayer during telephone contact;
- **Generation of Denial Letter.** If RCA concludes the penalty should be sustained, the program automatically generates a denial letter with an explanation of why the request was denied and the appeal rights available to the taxpayer;[9] and
- **IDRS Adjustments and Retention of Account History.** The system generates the Integrated Data Retrieval System (IDRS) adjustment action required and stores the history of the RCA action on the Integrated Case Processing (ICP) System for 13 months.[10]

If the RCA user disagrees with the system's conclusion, the employee has the option to override or abort the conclusion. A list of all RCA aborts is sent to the Office of Penalty and Interest Administration for review. If a trend emerges, or a certain IRS site is identified as overriding conclusions at a high rate, the IRS may provide RCA design changes or corrective training.[11] IRS employees have aborted approximately one percent (7,475) of all RCA conclusions from inception of the program in mid-2000 through June 22, 2005.[12]

Utilization of RCA

While the IRS developed RCA to ensure consistent administration of penalty relief, the IRS does not use the program for reasonable cause determinations on all types of penalties and it is not available to all IRS employees who make such determinations. The IRS uses RCA for reasonable cause determinations on Failure to Deposit penalties for business taxpayers, but not Failure to Pay and Failure to File penalties for business taxpayers, even if all three penalties are assessed on the same tax module. Further, revenue officers and revenue agents do not have access to the program even though they may make reasonable cause determinations. The only way to effectively utilize RCA to ensure consistent administration of penalty relief is to require its use for all reasonable cause determinations throughout the IRS.

The Treasury Inspector General for Tax Administration (TIGTA) recently released a

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9 IRM § 20.1.1.3.5.8; Attachment, Benefits of Using Reasonable Cause Assistant, Memorandum from the Director of Compliance Policy, Increased Oral Testimony Threshold for Granting Penalty Relief.

10 The retention period for RCA actions follows the retention period of ICP, which deleted account histories on accounts that are inactive for at least 13 months. However, the retention periods may change as Desktop Integration replaces ICP. The DI history retention requirements are not final at the time of this draft. Office of Penalty and Interest Administration Response to TAS Information Request (Oct. 11, 2005).

11 Office of Penalty and Interest Administration Response to TAS Information Request (Oct. 11, 2005); RCA Frequently Asked Questions (July 2001); Introduction to ICPNT, Unit 7: Reasonable Cause Assistant, Lesson 2: Other RCA Determinations, screen 63.

12 There were 657,120 RCA conclusions through June 2005. Office of Penalty and Interest Administration Response to TAS Information Request (Oct. 11, 2005).

report in which it found that revenue officers in the Collection Field Function did not retain adequate documentation to support reasonable cause abatement determinations. TIGTA also found that management information about penalty relief was unreliable because reasonable cause determinations were not properly coded on the Integrated Collection System (ICS).[13] It appears that the use of RCA could have prevented both of these problems.

Unnecessary Penalty Assessments

As illustrated in the following chart, there was a high rate of RCA abatement conclusions between January 2002 and June 16, 2005.[14]

TABLE 1.21.1, PERCENTAGE OF RCA ABATE AND SUSTAIN CONCLUSIONS

Clear Conclusions	Number	Abate	Sustain
1/1/2002 thru 12/31/2003	201,220	57.02%	42.98%
1/1/2004 thru 12/31/2004	269,947	60.33%	39.67%
1/1/2005 thru 6/16/2005	125,400	64.25%	35.75%

This large percentage of abatements suggests a need for systemic changes to minimize the assessment of penalties in the first place. The IRS has already attempted to minimize unnecessary assessments by systematically waiving FTD penalties on the first tax period following a change in deposit requirements.[15] The IRS should expand this approach to avoid assessing penalties that are likely to be abated based on reasonable cause.

The IRS should review RCA to determine under which circumstances assessed penalties are subsequently abated and apply its findings to the program that actually assesses penalties. For example, if a significant percentage of abatements are due to the first-time abatement exception, the IRS can run an account analysis prior to assessment to determine whether taxpayers qualify for the abatement. This approach would build efficiencies into the system by avoiding abatement requests from taxpayers proven to have a history of compliance.

The IRS could also send a "soft letter" with the actual tax assessment, informing the taxpayer a penalty will be assessed within 30 days unless the taxpayer provides a reason to abate. The letter could also include a form allowing the taxpayer to respond with reasons why the IRS should not assess the penalty. Information mailed with the letters

[13] Treasury Inspector General for Tax Administration, Ref. No. 2005-30-139, *Collection Field Function Penalty Abatements Need Proper Documentation and Coding* (Sept. 2005).

[14] Office of Penalty and Interest Administration Response to TAS Information Request (June 30, 2005). Note that in FY 2004, the IRS assessed approximately 28.6 million civil penalties. Approximately 13.6 percent of the assessed civil penalties were abated – 9.5 percent of the abatements based on reasonable cause. IRS, *2004 Data Book*, Table 27, Civil Penalties Assessed and Abated, by Type of Penalty and Type of Tax, Fiscal Year 2004.

[15] IRS Notice CP 235, *Federal Tax Deposit Penalty Waived Due to Change in Deposit Requirements* (Rev. 7-2000).

could include the definition of reasonable cause and describe some of the categories and circumstances qualifying for abatement. The IRS could then follow up with the taxpayer for further discussion or substantiation where appropriate.

Appeals' Reasonable Cause Abatements

Data from the IRS Office of Appeals, as shown in the following table, demonstrates that a significant percentage of post-assessment penalty determinations are reversed on appeal. Appeals has indicated that it only uses reasonable cause criteria in determining whether to abate a post-assessment penalty.[16]

TABLE 1.21.2, OFFICE OF APPEALS POST-ASSESSMENT PENALTY ABATEMENTS (RCA AND NON-RCA)

Fiscal Year	Penalty Fully Sustained	Number	Penalty Fully Abated	Number	Penalty Partially Abated	Number	Total Number Appeals
2002	31%	3,556	46%	5,300	23%	2,626	11,482
2003	33%	3,993	44%	5,254	23%	2,693	11,940
2004	31%	4,473	45%	6,574	24%	3,481	14,528
2005	28%	3,841	48%	6,702	24%	3,413	13,956

If reasonable cause is Appeals' only criterion for abating post-assessment penalties, it is noteworthy that Appeals abated approximately 44 to 48 percent of the post-abatement penalty cases in its inventory from fiscal years 2002 through 2005. It is important to note that this percentage is based on the total number of penalty appeals, which includes penalties not even addressed by RCA.[17] Further, the Appeals data does not distinguish between appealed penalty determinations made pursuant to RCA and those determined without the use of RCA.[18] Thus, the usefulness of the Appeals data is limited for purposes of evaluating RCA. Nonetheless, it demonstrates a need for the IRS to distinguish between RCA and non-RCA penalty determinations made by the Office of Appeals to measure the effectiveness of the RCA program.

Design of RCA

Taxpayer Advocate Service case advocates have raised the concern that RCA does not offer enough options to cover extenuating or mitigating circumstances. The system is extremely useful in reminding IRS employees of often-overlooked factors, such as those relevant to first time abatements.[19] However, the IRS needs to build flexibility into the

16 Office of Appeals Responses to TAS Information Requests (July 8, 2005 and Dec. 22, 2005).

17 IRM § 20.1.1.3.5.

18 RCA only determines Failure to File and Failure to Pay penalties for individual taxpayers (FTF and FTP) and Failure to Deposit (FTD) for business taxpayers. Information provided by IRS Office of Appeals (July 8, 2005).

19 Feedback from Survey given to Local Taxpayer Advocates (June 27, 2005) (47 TAS offices responded to the survey to share their experience with the RCA program).

system and train users to treat taxpayers fairly based on their own particular facts and circumstances. The system should not lead employees to assign a taxpayer to a particular RCA category of relief merely because none of the RCA options seem to apply exactly to the taxpayer's individual facts. Since the launch of the program, the IRS added a Guided Selection Option to RCA to explain the available RCA options to users who need help in selecting the appropriate category or categories for RCA consideration.[20] However, the IRS needs to review whether the system actually provides the user with the flexibility to fully consider the unique circumstances of some taxpayers and use discretion based on the particular facts of each case. The use of the RCA system should not eliminate common sense and good judgment on the part of IRS employees.

Ideally, the system should identify those unique cases needing further inquiry, such as a phone call[21] or additional review and consideration. For RCA to treat taxpayers in an equitable manner, the IRS needs to ensure that it assists the employee in identifying relevant mitigating factors to consider, and not become simply a checklist that replaces the exercise of discretion.

Overriding RCA Conclusions

While the use of RCA ensures the consistent treatment of penalty relief, the IRS should not discourage IRS employees from overriding RCA conclusions (referred to as "abort conclusions") when common sense dictates. Restricting the ability to override conclusions actually limits the user's discretion. Although there is no written policy explicitly limiting override conclusions, RCA training and procedures such as the following seem to discourage the practice.

- The IRS has stated in a "Frequently Asked Questions" document that the employee must have a "very good reason for changing the decision."[22]
- RCA training provides, "In rare circumstances, the abort button may be selected if you do not agree with the conclusion."[23] Further, the training provides, "Note: All abort conclusions generate a report for review by the Office of Penalty and Interest Administration. Therefore, use the Abort Conclusion button only when absolutely necessary."[24]
- The RCA Desk Reference Guide for RCA users states, "Selecting Abort Conclusion

20 Reasonable Cause Assistant (RCA) PowerPoint Presentation, Introduction to Phase 1.5 Enhancements.

21 The Taxpayer Advocate Service's Earned Income Tax Credit (EITC) Audit Reconsideration Study found that the likelihood of a taxpayer receiving additional EITC increased with the number of phone calls made by the TAS employee (as opposed to solely relying upon correspondence). National Taxpayer Advocate 2004 Annual Report to Congress vol. 2, at 1. Likewise, it may be argued that taxpayers would experience a higher rate of penalty abatement if they were contacted at least once by phone.

22 RCA Frequently Asked Questions (July 2001).

23 Introduction to ICPNT, Unit 7: Reasonable Cause Assistant, Lesson 1: Overview of RCA, screen 32.

24 Introduction to ICPNT, Unit 7: Reasonable Cause Assistant, Lesson 2: Other RCA Determinations, screen, 63; RCA Frequently Asked Questions.

> allows you the option to abort the conclusion. However, this option should be used only in special circumstances. A thorough explanation is required when using this option. All abort conclusions will be reviewed by the Office of Penalty and Interest."[25]

Further, the fact that RCA users aborted approximately one percent of total RCA conclusions from the launch of the program through June 2005 may be an indication of problems in the program.

The Office of Penalty and Interest Administration (OPI) has informed TAS that the reports generated by RCA listing overrides or abort conclusions are only used to determine if patterns or trends exist for certain substantive issues, or whether overrides are disproportionately concentrated in certain IRS locations. OPI has stated that it merely uses the reports to identify necessary training or design changes and the review does not lead to negative consequences for RCA users who override conclusions.[26] From the TAS perspective, however, it is unclear whether employees fully comprehend that choosing to override a conclusion will not affect their jobs. As noted above, IRS communications seem to discourage such practices.

Taxpayer Advocate Service case advocates, who are required to use RCA when making penalty abatement determinations, are well aware of their authority to override RCA conclusions.[27] In fact, the National Taxpayer Advocate has instructed TAS employees to use their own judgment before concurring with an RCA conclusion.[28] Thus, TAS case advocates review the automated conclusion to determine if other factors, which the system has not considered or given sufficient weight, might lead to a different result.

The IRS needs to effectively communicate to RCA users that it does not discourage them from overriding conclusions, and more importantly, that it will not penalize employees who do so. This effort requires a review of all RCA training material and guidance to ensure that nothing discourages employees from exercising their own discretion. Ideally, the training would provide good examples of when an override is appropriate.

25 IRS Document 11675, Reasonable Cause Assistant (RCA) Phase 1.5, Desk Reference Guide 13-1.

26 Office of Penalty and Interest Administration Response to TAS Information Request (Oct. 11, 2005).

27 TAS only utilizes RCA when the taxpayer makes an initial penalty abatement request or provides new information for consideration. Otherwise, the request is raised through TAS Operations Assistance Request (OAR) procedures to the Office of Appeals or to the IRS function that made the previous denial. *See* IRM § 13.1.4.2.2.6.2, -.3; IRM § 13.1.4.2.3.17.4, - .5.

28 Memorandum from Nina E. Olson, Mandatory Implementation of the Integrated Case Processing (ICP) System in TAS (Jan. 7, 2004); Feedback from Survey given to Local Taxpayer Advocates (June 27, 2005) (47 TAS offices responded to the survey to share their experience with the RCA program).

IRS COMMENTS

Penalty Relief using the RCA Program

In 1998, the IRS Penalty Task Group issued a report saying that the IRS was not consistent in granting relief from penalties when employees used their own discretion. This resulted in different treatment for similarly situated taxpayers and taxpayers "shopping" for abatements between different IRS offices and functions. These same issues were found in the 1979 and 1989 Civil Tax Penalties Reports, the Northeast Region's FTD Advocacy Project Report and the National Performance Review, as well as other reviews and audits.

In 1999, the Reasonable Cause Assistant (RCA) program, which was originally developed in the early 1990s, was revived based on the Penalty Task Group's recommendations. The IRS believes that the RCA program has significantly improved consistency in penalty administration.

The RCA program was developed to address the abatement of penalties for FTF and FTP by individuals and FTD by businesses. These are the penalties for which IRS employees can grant relief based on oral testimony from taxpayers. The oral testimony dollar threshold was raised based on the use of the RCA program, thus allowing Customer Service Representatives and other IRS employees to provide penalty relief to more taxpayers without written documentation. As noted by the National Taxpayer Advocate in her report, over a four year period the use of the RCA has resulted in more than 60 percent of cases receiving penalty abatements, with Appeals abating an average of 46 percent during the same period.

It is impossible for the RCA to address every potential issue raised by a taxpayer. The RCA Abort option is for use when the various relief categories do not adequately address a taxpayer's explanation and managerial assistance may be needed. The IRS will remind employees that the selection of "Abort" is not used to evaluate them, but will not encourage employees' use of the Abort option without justification.

The IRS is developing a proposal to implement, beginning in 2007, a systemic waiver of the three penalties (FTF, FTP, and FTD) based on the taxpayer's compliance history. Such a waiver should lead to a decrease of assessed penalties and in the number of abatements through the RCA. The IRS intends to send taxpayers a notice informing them of the penalty waiver.

The RCA's move to Desktop Integration (DI) from the Integrated Case Processing (ICP) will make it available to more employees, specifically revenue officers. In addition, in response to TIGTA's findings, Collection Policy issued a memorandum to the field, dated November 7, 2005, to address proper case documentation issues.

Generally, the IRS disagrees with the National Taxpayer Advocate's suggestions that the IRS should encourage the increased use of employee discretion in determining whether to abate penalties. The RCA program was implemented to decrease the use of discretion, which increased the consistency of penalty abatement determinations. The IRS does not believe that reverting to past practices is in the best interests of taxpayers.

Penalty Relief at Appeals

Appeals is restructuring its resources to better serve all taxpayers. There are several initiatives underway to improve the Penalty Appeals program, particularly in reducing processing time and better reporting of case resolution data. They are:

1. Centralizing and specializing Accounts Management-generated penalty cases at the Appeals Ogden campus operation; and,
2. Creating an automated closing document for penalty appeals cases to provide better reporting on case resolution.

The majority of Appeals penalty relief cases come from Accounts Management. As of October, 2005, Appeals has two groups of employees in its Ogden Campus Appeals office that resolve the majority of the Accounts Management-generated penalty appeals cases. This specialization will promote not only consistency of settlement, it will also improve Appeals cycle time in considering penalty relief cases.

It is important to note that Appeals generally resolves penalty disputes in a manner consistent with how TAS resolves these cases. Appeals is not bound by the RCA program's results and decides each case based on the documentation or explanations a taxpayer provides. There is, however, an important difference in how Appeals and how the RCA and TAS resolve these cases. Appeals has the authority to settle cases based on "hazards of litigation." A hazards settlement is defined as an intermediate resolution of an issue based on the fact that there is substantial uncertainty in the event of litigation as to how the court would interpret and apply the law or as to how the court would find the facts. In addition, Appeals does not currently capture data on cases it resolves where the taxpayer is providing documentation to the government for the first time. Better case resolution data will help identify these cases.

The National Taxpayer Advocate's principal concern regarding Appeals case resolution data on penalty appeals is the lack of availability to influence and improve the penalty process. Additionally, the National Taxpayer Advocate is concerned because Appeals does not track whether case determinations originate from the RCA tool. Appeals is addressing both of these issues.

Currently Appeals captures on IDRS the following Penalty Reason Codes used in case resolution:

PR Code	40	Appeals Abatement
	41	Appeals Sustains Penalties
	42	Appeals Partially Sustains Penalties

Appeals is developing better case resolution data that will offer greater insight into its determinations. This will include a new closing document that provides information currently not available -- specifically the underlying reasons for the resolution -- and additional disposal reason codes to further describe case resolutions. The codes will tie into the penalty reason codes used by Accounts Management, thus providing direct feedback on the decisions made by Accounts Management as well as the RCA tool itself. This data will be available from ACDS (the Appeals Centralized Database System) some time in FY 2006.

Currently, Appeals does not capture data regarding its case resolutions to differentiate RCA cases from non-RCA cases. Appeals will include in its new data collection whether the initial determination was made using the RCA tool.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the IRS for the progress it has made in the area of penalty assessments and abatements. We support the IRS's proposal under development to implement a systemic waiver of penalties based on the taxpayer's compliance history.[29] This approach would build efficiencies into the system by decreasing the number of assessed penalties that are consistently abated through RCA. It is also good customer service to send taxpayers a "soft" notice informing them of the penalty waiver and making them aware that a penalty will be imposed for the next violation.

We are pleased that Appeals is developing better case resolution data. This development will provide the IRS with a necessary tool to evaluate its penalty assessment and abatement programs, including RCA. With this additional information, the IRS will be able to identify specific problems and inefficiencies in the system, utilize the information to resolve the problems, and ultimately improve taxpayer service.

It is encouraging that more IRS employees who make penalty abatement decisions will have access to the program once RCA moves to Desktop Integration (DI). For purposes of consistency, the IRS should mandate that employees with access to RCA actually use RCA for abatement determinations, but only after they receive adequate training. The IRS should also consider using RCA for Failure to Pay (FTP) and Failure to File (FTF) penalties for business taxpayers.

We are pleased that the IRS plans to remind employees to abort RCA conclusions in appropriate instances and that such decisions will not impact performance evaluations. The IRS should revise training materials and other available guidance to ensure that this point is absolutely clear. We would be glad to join with the IRS to develop training

[29] The National Taxpayer Advocate submitted a recommendation to amend IRC § 6404 to authorize the Secretary of the Treasury to grant a one-time abatement of the Failure to File Penalty (IRC § 6651(a)(1)), and Failure to Pay Penalty (IRC § 6651(a)(2)) for first time filers and taxpayers with a consistent history of compliance where no countervailing factors are present. See National Taxpayer Advocate 2001 Annual Report to Congress 188.

and provide examples of penalty abatement cases. We note that the National Taxpayer Advocate did not suggest that the IRS allow employees to abort RCA conclusions where there is no justification. Rather, IRS employees should only use their discretion to override a conclusion when RCA does not offer a suitable option to address the taxpayer's particular facts and circumstances.

The IRS's response shows a real commitment to better serve taxpayers by improving its penalty assessment and abatement programs. We look forward to continual progress and hope to assist the IRS as it strives to further improve the system.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS take the following actions:

- Build on current efforts to reduce unnecessary penalty assessments by creating a cross-functional task force with representatives from the Taxpayer Advocate Service, the Office of Appeals, Management Information and Technology Service, W&I, SB/SE, and the Office of Penalty and Interest Administration. This group would identify the critical factors surrounding penalty assessments and abatements, the various systems used in making such determinations, and the structure for integrating the data between functions and taking corrective actions to minimize the burdens of the penalty process.
- Test sending a "soft letter" with the actual tax assessment in instances where the IRS would normally assess a penalty, to inform the taxpayer that a penalty will be assessed within 30 days unless the taxpayer provides a reason to abate it. The letter could also include a form allowing the taxpayer to respond with reasons why the IRS should not assess the penalty. Information mailed with the letters could include the definition of reasonable cause and some of the categories and circumstances qualifying for abatement. The IRS could then follow up with the taxpayer for further discussion or substantiation where appropriate.
- As RCA becomes more widely accessible to IRS employees through Desktop Integration, require the use of RCA after completion of adequate training by all personnel involved in reasonable cause abatement decisions. This requirement is critical to consistency in the abatement process.
- Revise RCA to incorporate abatement determinations for Failure to Pay and Failure to File penalties for business taxpayers.
- Review RCA and all related training and guidance materials to determine whether the application actually provides the user with the flexibility to fully consider unique facts and circumstances. The review should also include an analysis of penalty assessment and abatement data, a thorough examination of sample penalty abatement determinations, and a survey of RCA users.
- Standardize the review and reporting of RCA data by OPI. OPI should report its

findings to all RCA users and include basic communications about the effectiveness of the program as well as examples of common and unusual cases. RCA users can learn from the experiences of others, but they need a forum for receiving this information.

- Build on current IRS efforts to educate users regarding the appropriate use of abort conclusions. The IRS should revise all RCA training materials and guidance to clearly state that aborting a conclusion, or taking the necessary extra time to address unusual facts and circumstances, will not negatively impact users' performance evaluations. The IRS should also seek input from both the Taxpayer Advocate Service and the Office of Appeals during the revision.

INTRODUCTION

Section 7803(c)(2)(B)(ii)(VIII) of the Internal Revenue Code requires the National Taxpayer Advocate to include in her Annual Report to Congress, among other things, legislative recommendations to resolve problems encountered by taxpayers.

In the 108th Congress concluded a year ago, four proposals we recommended were enacted into law – a uniform definition of a child,[1] an "above-the-line" deduction for contingent attorney fees and attorney fee awards in certain nonphysical personal injury cases,[2] authorization for the IRS to enter into partial-pay installment agreements,[3] and the availability of income averaging for commercial fishermen.[4] In addition, at least a dozen of our recommendations passed either the full House as part of H.R. 1528, the Taxpayer Protection and IRS Accountability Act of 2003, or the full Senate as part of S. 882, the Tax Administration Good Government Act of 2004.[5]

During the first session of the 109th Congress, the Taxpayer Protection and IRS Accountability Act and the Tax Administration Good Government Act were not reintroduced, and Congress did not focus on tax administration issues in any significant way. The National Taxpayer Advocate encourages the House Ways and Means Committee and the Senate Finance Committee to give renewed attention to tax administration legislation in the coming year. IRS procedures and technological capabilities change over time, and it is important that the law keep up with IRS practices both to enable the IRS to do its job better and to protect taxpayer rights. The legislation that passed each House during the 108th Congress would be a good starting point.

We continue to advocate for the legislative recommendations we have made previously. In this report, we present seven new Key Legislative Recommendations and three new Additional Legislative Recommendations.

1 Working Families Tax Relief Act, Pub. L. No. 108-311, § 201 (2004).

2 American Jobs Creation Act, Pub. L. No. 108-357, § 703 (2004).

3 *Id* at § 843 (2004).

4 *Id* at § 314 (2004).

5 The House bill contained our recommendations to exempt husband-and-wife co-owned businesses from the partnership filing requirements in most cases; to convert the penalty for failure to pay estimated tax into an interest charge; to require that interest be abated on certain erroneous refunds; to authorize the Secretary to grant a one-time abatement of penalties for first-time filers or filers with a consistent history of compliance; to reduce the penalty for failure to make payroll tax deposits in the manner prescribed from 10 percent to two percent; to enhance the confidentiality of taxpayer communications with the Office of the Taxpayer Advocate; to give the National Taxpayer Advocate the authority to hire independent counsel; to authorize IRS employees to disclose information to local authorities when they hear imminent suicide threats; to authorize reinstatement of funds to retirement accounts when the IRS levied on the accounts in error or in flagrant disregard of rules or regulations; and to extend the time within which taxpayers or third parties can request a return of levied funds or the proceeds from the sale of levied property from nine months to two years from the date of levy. The Senate bill contained some of the foregoing recommendations as well as our recommendation to regulate unenrolled Federal income tax preparers.

KEY LEGISLATIVE RECOMMENDATIONS

Tax Reform Principles. Two months ago, the President's Advisory Panel on Federal Tax Reform submitted a report to the Secretary of the Treasury proposing significant revisions to the Internal Revenue Code, and it appears that Congress may give serious consideration to fundamental tax reform in the next year or two. We recommend that Congress give priority emphasis to six core principles as it considers various tax-reform proposals: (1) the tax system should not "entrap" taxpayers; (2) the tax laws should be simple enough so that taxpayers can prepare their own returns without professional help, simple enough so that taxpayers can compute their tax liabilities on a single form, and simple enough so that IRS telephone assistors can fully and accurately answer taxpayers' questions; (3) the tax laws should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance; (4) the tax laws should provide some choices, but not too many choices; (5) the tax laws should not necessarily avoid refundable credits but, if it includes them, should design them in a way that is administrable; and (6) the tax system should incorporate a periodic review of the tax code – in short, a sanity check.

Measures to Reduce Noncompliance in the Cash Economy. The IRS estimates the annual federal tax gap for 2001 was between $257 billion and $298 billion. The IRS receives about 130 million income tax returns each year. Thus, every taxpayer is forced to pay an average $2,000 "surtax" each year to subsidize noncompliance. IRS data show that the highest rate of noncompliance by far is attributable to transactions that are not reported to the IRS on a Form W-2, Form 1099, Schedule K-1, or similar form. These unreported transactions occur largely in the so-called "cash economy." To reduce the tax burden on compliant taxpayers, we recommend that Congress (1) create a three-pronged reporting and payment system that encourages compliance in certain cash economy transactions by (a) instituting backup withholding on payments to taxpayers who have demonstrated "substantial noncompliance"; (b) releasing backup withholding on payments to "substantially noncompliant" taxpayers who have demonstrated "substantial compliance" and agree to schedule and make future estimated tax payments through the IRS Electronic Funds Transfer Payment System (EFTPS); and (c) providing that payors will not be required to institute backup withholding on payments to independent contractors that present payors with a valid IRS "compliance certificate"; (2) require the IRS to promote making estimated tax payments through EFTPS; (3) authorize voluntary withholding agreements between independent contractors and service recipients; and (4) require third-party information reporting for applicable payments to corporations with 50 or fewer shareholders.

Tax Reform for Families: A Common Sense Approach. The Internal Revenue Code contains six provisions related to a taxpayer's family status: the Earned Income Tax Credit (EITC), the Child Tax Credit (CTC), the Child and Dependent Care Credit, personal and dependency exemptions, the head-of-household filing status, and the "separated spouse" rules of IRC § 7703(b). Each of these six provisions directly or indirectly confers a tax benefit on taxpayers who meet the various eligibility requirements, and at least one of these six provisions impacts every U.S. individual taxpayer. To build upon the recently enacted Uniform Definition of Child and to further simplify the family status provisions, we recommend that Congress (1) combine the exemptions, CTC, and part of the EITC and head of household filing status into a refundable Family Credit comprising two components – one for the taxpayer (and his or her spouse) and one for whomever is the "main carer" of a child or children based on a per-child amount; (2) separate the Child and Dependent Care Credits into two credits; (3) eliminate head-of-household filing status; (4) modify the EITC so that it provides a refundable credit to low income workers based solely on the taxpayer's earned income and is available to workers age 18 and over, regardless of the existence of children in the household; (5) permit married taxpayers who have a legal and binding separation agreement and who live separate and apart as of the last day of the calendar year to be considered "not married" for purposes of filing status; and (6) provide a separate credit for noncustodial parents of qualifying children who pay all child support obligations due for that calendar year.

Another Marriage Penalty: Taxing the Wrong Spouse. The federal income tax liabilities of married persons are often imposed on or collected from a spouse who did not earn the income subject to tax, i.e., the "wrong" spouse. Current law provides some relief to a spouse held liable for tax on the other spouse's income, at least in cases where the first spouse did not know about the income and did not significantly benefit from it. However, the relief rules are sometimes overly narrow, complex, costly for the IRS to administer, and burdensome for taxpayers. Even if relief rules apply so that one spouse is not liable for his or her spouse's tax, the IRS may be able to collect the liability from the non-liable spouse in community property states. We recommend that Congress amend the law to tax the "right" spouse in the first instance and to prevent the IRS from undermining this rule through its collection efforts. Our recommendation would better align each person's tax with his or her individual ability to pay, significantly reduce complexity, and minimize the impact of state property and collection laws that subject taxpayers to different amounts of federal income tax solely because they reside in different states.

Requiring Brokers to Track and Report Cost Basis for Stocks and Mutual Funds. Many financial institutions through which investors own stocks and mutual funds ("brokers") do not currently keep track of an investor's basis in the stocks or mutual funds, and no brokers report basis information to both taxpayers and the IRS on a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*. The absence of information reporting creates serious problems for many taxpayers and the government alike. For taxpayers, tracking basis can be extraordinarily complex and many taxpayers seeking to comply with the law find they simply cannot do so with accuracy, leaving them exposed if audited. From the government's perspective, the absence of information reporting enables underreporting by taxpayers who deliberately overstate their basis (thereby reducing their gain or even generating a loss), because they know the IRS generally cannot detect errors in basis reporting in the absence of an audit. One recent estimate puts the revenue loss to the government from such underreporting at $250 billion over the next 10 years. We recommend that brokers be required to keep track of an investor's basis, transfer basis information to a successor broker if the investor transfers the stock or mutual fund holding, and report basis information to the taxpayer and the IRS (along with the proceeds generated by a sale) on Form 1099-B. To offset the cost of implementing a tracking system, we note that Congress could provide a one-time tax credit for brokers.

Tracking Cost Basis as a Result of Estate Tax Repeal. Under the current estate tax regime, persons acquiring property from a decedent are able to use a "stepped-up" basis equal to the fair market value of the property at the date of the decedent's death (or, if they so elect, on the date six months after the decedent's death). Once the estate tax is repealed in 2010, these taxpayers must use the modified carryover basis, which may require extremely complex calculations to determine the property's adjusted basis in the hands of the decedent just prior to death. Reconstructing adjusted basis in property is difficult enough while taxpayers holding such assets are alive; after death, it can become impossible. Congress should explore ways to lessen this compliance burden.

Restructuring and Reform of Collection Due Process Provisions. Collection Due Process (CDP) hearings afford taxpayers the opportunity to obtain meaningful review of IRS collection actions by an impartial IRS Appeals Officer and the courts, either after the initial filing of a Notice of Federal Tax Lien or before an initial levy on a taxpayer's assets. The current statutory CDP rights are both under-inclusive and over-inclusive, denying judicial review of some lien and levy actions while encouraging counterproductive behavior on the part of some taxpayers and the IRS. To enhance taxpayer protections in the tax collection process while ensuring that the IRS's ability to collect the correct amount of tax is not unreasonably impaired, we recommend that Congress (1) require the IRS to issue a separate CDP Right to Hearing notice at the time it undertakes the first levy action with respect to a tax, describing with specificity the levy source and date such levy will occur and providing the taxpayer with the name and contact information of an IRS employee to call about the levy action; (2) consolidate judicial review of CDP hearings in the United States Tax Court, clarify the role and scope of Tax Court oversight of Appeals' continuing jurisdiction over CDP cases, and address the Tax Court's standard of review for the underlying liability in CDP cases; and (3) codify both the IRS Collection Appeals Program (CAP) and the IRS Audit Reconsideration Process and specifically include Audit Reconsideration as an alternative to be considered at CDP hearings.

ADDITIONAL LEGISLATIVE RECOMMENDATIONS

Direct Deposit of Income Tax Refunds. Under present law, there are no procedures in place for the IRS, the government's Financial Management Service (FMS), and financial institutions to address inadvertent errors by taxpayers relating to direct deposits of tax refund checks. Disputes over the accuracy of a direct deposit refund due to taxpayer or preparer error must currently be resolved between the taxpayer and the financial institution itself, with little assistance from the IRS. The National Taxpayer Advocate recommends that Congress amend the Internal Revenue Code to create a process through which the IRS and financial institutions work together to identify the incorrect recipient of a direct deposit refund and require the return of the improperly deposited funds.

Social Security Levies. Current law exempts from IRS levy certain pension and annuity payments (including payments under the Railroad Retirement Act), but it does not exempt retirement, survivors, and disability insurance payments made under the Social Security Act from levy. Levies by the IRS on Social Security benefits can cause particularly severe hardships for low income taxpayers who rely on these payments as their primary or sole source of income. The National Taxpayer Advocate recommends that Congress exempt Social Security payments altogether from IRS levy. In the alternative, the National Taxpayer Advocate recommends that Congress extend the exemption amount applicable to manual levies to automated levies under the Federal Payment Levy Program.

Debt Collection Techniques on EITC Benefits by the Refund Anticipation Loan Industry. Refund anticipation loan (RAL) customers may not completely understand the ramifications of the debt offset collection provisions included in standardized RAL contracts. The provisions give the contracting financial institution or bank the authority to offset RAL proceeds to satisfy outstanding delinquencies owed on RALs previously issued by either the contracting bank or a third-party bank. The practice allows banks to effectively seize EITC benefits and transfer the funds to themselves or third-party banks to satisfy these prior delinquencies. The National Taxpayer Advocate recommends that Congress amend IRC § 32 to prohibit banks from exercising their right to set off on EITC benefits, a protection that currently exists for Social Security benefits. At the very least, the law should prohibit banks from transferring any portion of a federal tax refund representing the EITC to a third-party bank.

STATUS OF THE NATIONAL TAXPAYER ADVOCATE'S LEGISLATIVE RECOMMENDATIONS, 109TH CONGRESS

Recommendation	Bill No.	Sponsor	Date	Current Status
Alternative Minimum Tax				
Repeal the Individual AMT	HR 1186	English	3/9/2005	Referred to the Ways & Means Committee
	S 1103	Baucus	5/23/2005	Referred to the Senate Finance Committee
	HR 2950	Neal	6/16/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Index AMT exemption	HR 703	Garrett	2/9/2005	Referred to the Ways & Means Committee
	HR 4096	Reynolds	10/20/2005	Passed House 12/7/2005; Placed on Senate Legislative Calendar 12/13/2005.
Tax Preparation and Low Income Taxpayer Clinics				
Matching Grants for LITC for Return Preparation	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Senate Finance Committee
Regulation of Income Tax Return Preparers	HR 894	Becerra	2/17/2005	Referred to the Financial Institutions and Consumer Credit Subcommittee
	S 832	Bingaman	4/18/2005	Referred to the Senate Finance Committee
Small Business Issues				
Health Insurance Deduction/Self-Employed Individuals	S 663	Bingaman	3/17/2005	Referred to the Senate Finance Committee
Married Couples as Business Co-owners	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2//2005	Referred to the Ways & Means Committee
Federal Tax Deposit (FTD) Avoidance Penalty	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee
Election to be treated as an S Corporation	HR 3629	Doggett	7/29/2005	Referred to the Ways & Means Committee
	HR 3841	Manzullo	9/2/2005	Referred to the Ways & Means Committee

1 KEY LEGISLATIVE RECOMMENDATION: A TAXPAYER-CENTRIC APPROACH TO TAX REFORM

PROBLEM

In our 2004 Annual Report to Congress, the National Taxpayer Advocate identified the "Confounding Complexity of the Tax Code" as the most serious problem facing taxpayers. This complexity imposes enormous and unacceptable burdens on taxpayers.

Tax law complexity shows up in many areas. For starters, the Internal Revenue Code itself is approximately 1.5 million words long,[1] with one popular version encompassing 9,540 pages of text, along with five volumes of regulations.[2] Approximately 61 percent of individual taxpayers pay for tax preparation,[3] as do an astounding 68 percent of low income taxpayers who claim the Earned Income Tax Credit (EITC).[4] The IRS estimates the paperwork burden of completing a Form 1040 to be 13.7 hours,[5] and a leading academic estimates the overall compliance burden for individual and business taxpayers to be $125 billion.[6] Meanwhile, an entire industry has built up around taxes that extends beyond the mere acts of preparing and filing returns. Taxpayers now pay for tax preparation software, for filing electronically, for "audit insurance," and for Refund Anticipation Loans and Refund Anticipation Checks. Tax refunds are cross-marketed with debit cards for discount stores, furniture rentals, mortgages, and used cars.

The tax law is so complicated that the IRS limits the types of returns it will prepare for taxpayers in its walk-in sites or that it will allow Volunteer Income Tax Assistance (VITA) sites to prepare, even as it directs more and more taxpayers to those sites for assistance. In fact, the IRS designates entire areas of taxpayer questions "out of scope" for its assistors to answer.

Tax rules and regulations are the Number One headache for small business. And at the top of every complexity list is the Alternative Minimum Tax (AMT), which will impact 34.8 million individual taxpayers – fully 34 percent of all individual taxpayers – in

1 A study published in April 2001 by the Joint Committee on Taxation put the number of words in the Code at approximately 1,395,000. *See* Staff of the Joint Committee on Taxation, 107th Cong., Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (vol. I), 4 (Comm. Print 2001). Subsequent tax legislation has expanded the number of words considerably.

2 The Complete Internal Revenue Code – All the Income, Estate & Gift, Employment, Excise, Procedure and Administrative Provisions (updated to reflect all tax legislation through December 1, 2004), Research Institute of America, (December 2004); Federal Tax Regulations – Complete text of all final, temporary and proposed Treasury Regulations pertaining to income tax, estate tax, gift tax, employment tax, procedure, administration, and excise taxes, Research Institute of America, (January 2004).

3 IRS Office of Research, *Taxpayer Usage Study Weekly Report* (August 27, 2004).

4 Wage and Investment Research, *Tax Year 2004 EITC Numbers* (through June 30, 2005).

5 Instructions for Form 1040, U.S. Individual Income Tax Return (2005).

6 Joel Slemrod, *The Costs of Tax Complexity: Presentation to the President's Advisory Panel on Federal Tax Reform* (March 3, 2005).

2010.[7] Many more will complete the AMT calculations only to learn that they do not owe the tax.

From the perspective of taxpayers, then, the time is clearly ripe for tax reform. Our tax system, as currently structured, makes it too difficult for taxpayers and employers to achieve compliance, and for the IRS to encourage compliance and enforce the laws. Tax reform is no longer a luxury, something to discuss at conferences and on talk shows. It has become a necessity.

Know your Taxpayer

The starting point for tax reform should be an acknowledgement that the federal tax system represents a social contract between the federal government and its taxpayers. Taxpayers agree to voluntarily come forward to report their income and pay taxes on that income. In return, the federal government commits to making that process as simple and unburdensome as possible, including providing the necessary assistance and service, while it ensures that all taxpayers pay their fair share of tax.

For this social contract to succeed, the tax system must acknowledge the basic characteristics of its taxpaying population and not impose such complexity that compliance is beyond the comprehension or reach of much of the public. Tables 2.1.1 and 2.1.2 show some of these taxpayer characteristics for Tax Year 2002.

TABLE 2.1.1, TY 2002 TAXPAYER CHARACTERISTICS

Median Adjusted Gross Income	**$28,281**
Median Wages	$27,396
Median Schedule C	$2,980
Median Schedule F	($3,436)
Filing Status	
Married/Joint	40%
Married/Separated	2%
Single	44%
Head of Household	14%

[7] Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004).

TABLE 2.1.2, TY 2002 TAXPAYER CHARACTERISTICS

	% of Returns	Number/Amount
Median Number of Children	36%	2
Deductions		
Median standard deduction	64%	$4,700
Median itemized deduction	36%	$14,450
Retirement Deductions		
Mean IRA	3%	$2,887
Mean Keogh	1%	$13,775
Median Refund	80%	$1,274
Returns Paid in Full	15%	$803
Unpaid balance due returns	5%	—

Projections about the taxpaying public of 2010 identify some interesting trends. Married couples with children are projected to constitute 22 percent of households, down from 31 percent in 1980.[8] Persons who live alone, with non-relatives, or in a family of non-married relatives will make up 49.6 percent of households, up from 39.1 percent in 1980.[9] Moreover, the foreign-born and immigrant population is projected to be 11.3 percent (34 million) of the U.S. population, up from 10.4 percent (28.4 million) in 2000.[10] In 2000, fifty-one percent of the foreign-born population was from Latin America and 26 percent from Asia. Between 2002 and 2007, the Hispanic population will grow nearly 9 percent while the Asian population is expected to grow 27 percent.[11] By 2010, 21 percent of the population will speak a language other than English in their homes.[12]

People age 55 and older are projected to make up 17 percent of the labor force, compared with 13 percent in 2000.[13] Internet use will be lowest among people who are over 50, receive incomes below $35,000, have a high school or lower education level, or live in non-family households.[14] These projections are important since they are related to the ability of taxpayers to understand the tax code and comply with tax obligations. They also have consequences for tax reform, if one believes the tax code should reflect the life circumstances of its taxpayers.

8 W&I Research, *Wage & Investment Taxpayer of the Future* vi (January 2003).

9 *Id*. at 23.

10 *Id*. at 11.

11 *Id*. at 12 (citing *American Demographics).*

12 *Id*. at 14. Other than English, Spanish is the language most commonly spoken in U.S. homes. *Id.*

13 *Id*. at viii.

14 *Id*. at viii-ix.

RECOMMENDATIONS

Based on our experience assisting and advocating for taxpayers, we offer here six general principles that we believe should guide policy makers and legislators as they undertake fundamental tax reform.

1. The tax system should not "entrap" taxpayers.

The tax law should not contain arcane and technical "gotchas" such as the AMT, which is unpredictable in its application and penalizes aspects of taxpayers' lives such as having children or residing in a high-tax state. Complexity such as this breeds disrespect for the tax law and feeds the average taxpayer's suspicion that the government does not care whether it imposes burden on its taxpayers.

2. The Internal Revenue Code should be simple enough so that taxpayers can prepare their own returns without professional help, simple enough so that taxpayers can compute and report their tax liabilities on a single form, and simple enough so that IRS telephone assistors can fully and accurately answer taxpayers' questions.

Most individual taxpayers have fairly simple economic lives. Designing a system that treats basic economic transactions in an uncomplicated fashion will ensure that inadvertent errors will be minimal (because taxpayers will understand the rules). Where exceptions to general rules are necessary to maintain fairness, efficiency, or administrability, these exceptions should be designed so as not to add complexity for all taxpayers.

Accomplishing this, of course, is no easy task. The law must reflect the manner in which taxpayers live their lives yet, paradoxically, must deal with the diversity of those lives. In some instances the law must incorporate flexibility into its design.[15] In other instances, the law should establish a single standard so that taxpayers in diverse jurisdictions are treated uniformly.[16]

A well-designed tax system is one that taxpayers can understand and that the majority of taxpayers can participate in without the assistance of third parties, if they so desire. Filing and paying taxes is part of a taxpayer's dialogue with his or her government. Taxpayer awareness of what income is taxable, what expenses are deductible, what behavior is encouraged by the government, and what share each taxpayer bears of government activity is an important check and balance on government. This sanity check is diluted and even eliminated when complexity drives the majority of taxpayers to turn the job over to professionals.[17]

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[15] *See, e.g.,* Key Legislative Recommendation: *Tax Reform for Families: A Common Sense Approach, infra.*

[16] *See, e.g.,* Key Legislative Recommendation: *Another Marriage Penalty: Taxing the Wrong Spouse, infra.*

[17] The act of reporting one's income and expenses to the government should not be an opportunity for purveyors of ancillary, non-tax related products to sell their goods and services. Moreover, where the participation of third parties is demonstrated to improve compliance, there must be sufficient government oversight of these third parties. *See* Most Serious Problem: *Regulation of Electronic Return Originators, supra*; National Taxpayer Advocate 2004 Annual Report to Congress, 87; National Taxpayer Advocate 2002 Annual Report to Congress, 69; National Taxpayer Advocate 2002 Annual Report to Congress.

A tax law that is so complex that even the tax agency cannot answer questions for fear of giving the wrong answer creates compliance problems for taxpayers and forces the tax agency to undertake examination and collection activity that could be avoided. In enacting tax laws, Congress should consult and work with the IRS to determine whether and how that law can be explained in plain English, in forms and publications, and over the phone. Moreover, policymakers and legislators should routinely ask themselves the following questions: What steps are we requiring taxpayers to take? Does the impacted taxpayer population have the capacity or ability to comply with these requirements? Will that population have to seek the assistance of third parties in complying with the law? Are these requirements imposing an undue burden on taxpayers that will lead to noncompliance, inadvertent or otherwise?

3. The tax system should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance.

The tax system should identify compliance problem areas and provide the tax administrator with the necessary legal authority and tools to address those areas administratively and in the courts. We know, for example, that income that is not reported to the IRS by a third party provides an opportunity for understating income and therefore tax liability.[18] Thus, income should be subject to information reporting to the maximum extent possible in order to reduce opportunities for noncompliance. This approach would give taxpayers confidence that others are paying their fair share – which is key to building and maintaining public confidence in the fairness of the system – and would enable the government to more easily collect the tax that is due.

We also know that many taxpayers in small business struggle to pay their daily bills – often spending every dollar that comes into their businesses to keep the businesses afloat. The inability to save, even for legal obligations such as payroll or income taxes, is well-documented. We can reduce this noncompliance by developing procedures that help the small business taxpayer pay over his taxes in a timely fashion, so that he is not tempted to apply funds to other needs. Elsewhere in this report, we discuss some of these procedures, including requiring the monthly payment of estimated taxes, encouraging voluntary withholding agreements between independent contractors and service recipients, authorizing backup withholding on noncompliant independent contractors, and establishing an exemption program for compliant independent contractors.[19]

4. The tax law should provide some choices, but not too many choices.

Choice is good – it acknowledges the diversity of human experience – but too many choices are confusing. Do we really need nine different education provisions in the Code or a dozen different retirement saving vehicles? This kind of complexity leads tax-

[18] *See* Most Serious Problem: *The Cash Economy, supra.*

[19] *See* Most Serious Problem, *The Cash Economy, supra*; Key Legislative Recommendation, *Measures to Reduce Noncompliance in the Cash Economy, infra.*

payers to believe there is something they are missing out on – did they make the right choice? Taxpayers are left in a state of chronic uncertainty.

5. Refundable tax credits are not inherently problematic – it's all in the design.

There are many reasons why we might want to use a refundable tax credit to deliver a benefit to taxpayers that could also be structured as a direct spending program. For example, if income is a key eligibility requirement, the program may be administered best through the tax code.

With refundable credits, however, we do need to understand the characteristics of any provision's target population, and we should treat the credit as a separate program within the tax system. That is, we need to think through the elements and the opportunities for noncompliance, and then administer the refundable credit programmatically. There should be a single point of administrative oversight, with authority over education, outreach, and enforcement initiatives, tailored to the program and its recipients.

6. The tax system should incorporate a periodic review of the tax code – in short, a sanity check.

Congress should impose a mechanism on itself that checks for complexity creep. This mechanism could include a mandated periodic review by the Joint Committee on Taxation of entire segments of the tax laws, on a rolling five-year cycle, so that deadwood provisions are eliminated, archaic requirements are updated, "complexity creep" is identified, and changes in economic and technological conditions are considered.

2 KEY LEGISLATIVE RECOMMENDATION: MEASURES TO REDUCE NONCOMPLIANCE IN THE CASH ECONOMY

PROBLEM

In the Most Serious Problem section of this Report, the National Taxpayer Advocate lists unreported income attributable to the "cash economy" as one of the most serious problems encountered by taxpayers and the IRS, and cites evidence suggesting that unreported income from the cash economy may be the single largest component of the annual $257 to $298 billion net federal tax gap.[1] There is no recognized uniform definition of the cash economy. For purposes of this section of the Annual Report to Congress, we use the term "cash economy" to mean payments for transactions that are not reported to the IRS.[2] The IRS estimates that taxpayers report only a low percentage of income earned from these transactions.[3] Cash economy transactions are difficult to quantify, however, because they are, by definition, unreported. These unreported transactions can easily slip below the IRS's radar screen and present an almost unlimited opportunity for noncompliance. These noncompliance opportunities appeal not only to those taxpayers who deliberately seek to skirt their tax obligations, but also to those taxpayers who may use unreported transactions as a cash flow cushion or who believe that only reported income is taxable.[4]

In contrast, taxpayers report nearly all income from transactions that are reported to the IRS. Taxpayers report 99 percent of the income subject to withholding and 96 percent of income subject to third-party information reporting.[5] Unfortunately, these compliant taxpayers are left holding the bag for a $2,000 per return "surtax" to make up the tax gap difference attributable to the noncompliant.[6]

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1 *See* Most Serious Problem: *The Cash Economy supra.*

2 For a similar definition of the cash economy, *see* Bridging the Tax Gap: Hearing Before the Committee on Finance, United States Senate, 108th Cong., 21 (July 21, 2004) (statement of Professor Joseph L. Bankman defining the cash economy as "legal business transactions conducted in cash (or checks) that are not subject to withholding or third-party information reporting… your gardener, the family that owns the corner restaurant. Anyone that is getting cash or checks that is not subject to third-party reporting").

3 Only 68 percent of income not subject to withholding or information reporting is reported to the IRS. This percentage drops to 20 percent for income earned by certain sole proprietors (called "informal suppliers") who operate "off the books" on a cash basis in areas such as street vending, door-to-door sales or moonlighting in a trade of profession. IRS National Headquarters, Office of Research, *Interactive Tax Gap Map for Year 2001,* 22-23 (Feb. 24, 2004).

4 *See* Uncollected Taxes: Can We Reduce the $300 Billion Tax Gap? Hearing Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, United States Senate, 109th Cong. 1st session (2005) (statement of Nina E. Olson, National Taxpayer Advocate).

5 IRS National Headquarters, Office of Research, *Interactive Tax Gap Map for Year 2001,* 22-23 (Feb. 24, 2004).

6 The IRS receives approximately 133 million individual income tax returns each year. IRS Pub. 1136, *Statistics of Income Bulletin, Spring 2005* (Feb. 2004) (Table 22). The lower range of the net tax gap ($257 billion) divided by the number of individual income tax returns (133 million) is $1,932 per return. The upper range of the net tax gap ($298 billion) divided by the number of individual income tax returns (133 million) is $2,240 per return.

In the Most Serious Problem section of this Report, the National Taxpayer Advocate makes several administrative recommendations that, if implemented, would curb noncompliance in the cash economy. Administrative recommendations alone, however, are not sufficient. Because tax withholding, reporting, and payment requirements are statutory, legislative action is also needed to reduce the tax gap with respect to the cash economy.

The National Taxpayer Advocate offers the following legislative recommendations that, if enacted, would promote compliance and reduce noncompliance in the cash economy.

GENERAL RECOMMENDATIONS

1. Amend IRC § 3406 to create a three-pronged reporting and payment system that encourages compliance in certain cash economy transactions by:
   - Instituting backup withholding on payments to taxpayers who have demonstrated "Substantial Noncompliance";
   - Releasing backup withholding on payments to Substantially Noncompliant taxpayers who have demonstrated "Substantial Compliance," and who agree to schedule and make future estimated tax payments through the IRS Electronic Funds Transfer Payment System (EFTPS); and
   - Providing that payors will not be required to institute backup withholding on payments to taxpayers (independent contractors) who present payors with a valid IRS "Compliance Certificate."
2. Amend IRC § 6302(h) to require the IRS to promote making estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.
3. Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding agreements between independent contractors and service-recipients (as defined in IRC § 6041A(a)(1)), and to specify that independent contractors who enter into voluntary agreements with payor service recipients will be treated as employees only to the extent specified in the agreement, and allow such independent contractors to continue to deduct ordinary and necessary business expenses under IRC § 162(a).
4. Amend IRC § 6041A to require third-party information reporting for applicable payments to corporations, as defined in IRC § 7701(a)(3) (including corporations electing to be taxed under subchapter S of the Internal Revenue Code), with 50 or fewer shareholders.

RECOMMENDATION ONE

Create a three-pronged reporting and payment system that encourages compliance in certain cash economy transactions by (1) instituting backup withholding on payments to taxpayers that have demonstrated "Substantial Noncompliance"; (2) releasing backup withholding on payments to Substantially Noncompliant taxpayers that have demonstrated "Substantial Compliance," and who agree to schedule and make future estimated tax payments through the IRS Electronic Funds Transfer Payment System (EFTPS); and (3) providing that payors will not be required to institute backup withholding on payments to taxpayers (independent contractors) who present payors with a valid IRS "Compliance Certificate."

ILLUSTRATION OF PROPOSAL

Taxpayer is an independent contractor who performs various construction related services. Taxpayer currently operates in the cash economy and does not file returns or pay taxes. The IRS discovers Taxpayer through its Information Returns Processing (IRP) Nonfiler program. The IRS has no record of Taxpayer ever filing a federal tax return or paying taxes and therefore determines that Taxpayer is "Substantially Noncompliant" as defined by regulation. The IRS contacts the businesses that made payments to Taxpayer (as listed on the IRP documents) and tells them to institute backup withholding, under IRC § 3406, on future payments to Taxpayer. The IRS also records Taxpayer's name and Taxpayer Identification Number (TIN) on the electronic TIN matching program database.[7] When a business planning to pay Taxpayer for services submits Taxpayer's TIN for verification through the electronic matching program, the IRS will return a "match indicator" indicating that backup withholding is required on payments to Taxpayer.

When Taxpayer is discovered through the IRP, the IRS issues Taxpayer a notice, via certified mail, explaining that future payments to Taxpayer are subject to backup withholding because he has been Substantially Noncompliant in prior tax years. The notice also tells Taxpayer that the IRS will release backup withholding if Taxpayer (1) becomes compliant by filing returns and paying back taxes (even if through an installment agreement or Offer in Compromise), (2) agrees to use the IRS Electronic Funds Transfer Payment System (EFTPS) to pay future estimated taxes, and (3) provides the IRS with a one-year EFTPS estimated tax payment schedule.

The IRS also sends a notice to all businesses that have been required to institute backup withholding on payees that (1) are subject to backup withholding under the current provisions of IRC § 3406 (i.e., missing TIN, incorrect TIN, or TIN/name mismatch)[8] or (2) are subject to backup withholding under the proposed Substantially Noncompliant provisions of IRC § 3406. This notice explains that backup withholding on payments

[7] For a detailed discussion of the IRS electronic TIN matching program, *see* Most Serious Problem, Backup Withholding, *supra*.

[8] *See* backup withholding present law discussion, *infra*.

to additional payees can be avoided if the payees present the payor with an IRS issued "Compliance Certificate." Payees can obtain a compliance certificate from the IRS by demonstrating compliance (i.e., filing and paying) for a period of two consecutive years.

SPECIFIC RECOMENDATIONS

To implement this three-pronged approach, Congress should:

Amend IRC § 3406 to:

- Require backup withholding on payments to certain taxpayers that are determined "Substantially Noncompliant" with federal tax laws, as defined in regulations prescribed by the Secretary of the Treasury (Secretary).
- Release backup withholding on Substantially Noncompliant taxpayers that (1) demonstrate "Substantial Compliance," as defined in regulations prescribed by the Secretary, (2) agree to make future estimated tax payments through the IRS Electronic Funds Transfer Payments System (EFTPS), and (3) provide the IRS with a one-year EFTPS estimated tax payment schedule.
- Authorize the Secretary to prescribe regulations that set forth industry or industry segment compliance standards. If the IRS, using these standards, determines that a substantial number of independent contractors operating in an industry or industry segment are Substantially Noncompliant, then payors in such industry or industry segment shall institute backup withholding on payments made, in the course of a trade or business, to independent contractors.
- Authorize the Secretary to prescribe regulations that create a federal tax "Compliance Certificate" for certain taxpayers conducting business as independent contractors, and set forth the requirements for obtaining a Compliance Certificate from the IRS. These requirements could include such measures as prior filing and payment activity, valid TIN use, and agreeing to use EFTPS for future estimated tax payments.
- Provide that backup withholding is not required for payments made to any payee that presents the payor with a valid "Compliance Certificate."

PRESENT LAW

Backup Withholding

IRC § 3406(a)(1) requires a payor making any reportable payment to withhold 28 percent[9] of such payment if (1) the payee fails to furnish his TIN to the payor in the manner required,[10] (2) the Secretary notifies the payor that the TIN furnished by the

[9] IRC § 3406(a)(1) requires the payor to deduct and withhold from such payment a tax equal to the product of the fourth lowest rate of tax applicable under IRC § 1(c), which is 28 percent for tax year 2005.

[10] A payor may use Form W-9, *Request for Taxpayer Identification Number and Certification*, to obtain a payee's name, TIN and entity type.

payee is incorrect, (3) the Secretary notifies the payor to start withholding on interest and dividend payments because the payee did not report income on all of his interest or dividend income in prior years, or (4) the payee did not certify, when required, that he is not subject to backup withholding on interest and dividends.[11]

Payors falling into the first two categories are subject to backup withholding under the IRS's "B" backup withholding program. Under the B withholding program, the IRS notifies payors who file information returns with incorrect TINs. A payor receiving a notice must then determine, for each payee who has provided an invalid TIN (or no TIN at all), how many times within three calendar years the IRS has notified the payor that the payee's TIN was invalid and respond accordingly:

First Notice: Request a valid TIN from the payee, using Form W-9, *Request for Taxpayer Identification Number and Certification*. If the payee does not respond to this request, begin backup withholding until the payee returns the Form W-9.

Second Notice: Validate the payee's TIN with the IRS or Social Security Administration (SSA). The payor may begin backup withholding upon receiving a second notice, but *must* begin backup withholding if the IRS or SSA does not validate the payee's TIN within 30 business days.

No TIN: Payors who receive no TIN from a payee must begin immediate backup withholding. No IRS notice is required.[12]

IRC § 6723 imposes a $50 penalty when a payee fails to provide a payor with a correct Form W-9 (up to a maximum of $100,000 per year).

In 2004, the IRS introduced an electronic TIN matching program allowing authorized payors[13] of income subject to backup withholding to match Form 1099 payee information against IRS records over the internet before filing information returns. The TIN matching program returns a "match indicator" for each submitted name/TIN combination. A payor will receive the match indicators in "real time" for submissions of 25 name/TIN combinations or less. Match indicators for larger submissions are returned within 24 hours.[14]

Information Reporting

IRC § 6041A(a) requires a service-recipient to report payments of $600 or more made

[11] For a detailed discussion of backup withholding, *see*, Most Serious Problem, Backup Withholding, *supra*.

[12] IRC § 3406(a)(1)(A).

[13] An authorized payor is one that has filed information returns with the IRS in at least one of the two past tax years.

[14] For a more detailed discussion of the electronic TIN matching program *see* Most Serious Problem: *Backup Withholding, supra*.

in the course of a trade or business to a person for services performed. These payments are generally reported on IRS Form 1099-MISC, Miscellaneous Income. IRC § 6721(a) imposes a $50 per return penalty on Service-recipients that fail to file required Forms 1099-MISC (up to a maximum of $250,000 per calendar year).

REASONS FOR CHANGE

One component of the cash economy is unreported payments to independent contractors for services. Unreported payments to independent contractors include:

- Deliberate "under the table" cash payments.
- Payments that are reported with an invalid TIN or a payee/TIN mismatch.
- Payments subject to information reporting, that are not reported.[15]

Current withholding and information reporting provisions do not adequately capture income from transactions in the cash economy. Withholding is not required on payments to non-employees, and skirting information reporting requirements for payments to independent contractors is easy and relatively painless. The IRS can catch some of these "off the books" payments to independent contractors through its Information Returns Processing (IRP) program or through direct audits; but when neither payor nor payee reports a payment, there is generally little evidence that a payment was made at all.[16] Even payors wishing to comply with their information reporting obligations may be reporting payments to independent contractors that have supplied invalid TINs. Under existing provisions, these payors may not know that a payee's TIN is invalid until several payments have been made and the payee has moved on to other jobs.[17]

Furthermore, the motivation to comply with current Forms 1099-MISC and W-9 requirements is not particularly compelling. The toll charge for a missing or incorrect Form 1099-MISC or W-9 is $50. And this charge will only be imposed if the IRS actually catches a Form 1099-MISC or W-9 discrepancy.

Explanation of Recommendation

In her 2003 Annual Report to Congress, the National Taxpayer Advocate addressed the problem of noncompliance by certain independent contractors and suggested that Congress consider a withholding scheme on payments to independent contractors as a starting point for discussions on ways to address the tax gap.[18] After discussing this proposal with many interested stakeholders, we determined that universal withholding

[15] Unreported payments to independent contractors for services also include payments of less than $600 per year, payments that are not made in the course of a payor's trade or business, and payments made to certain corporations. IRC § 6041A.

[16] *See* Most Serious Problem: *The Cash Economy, supra.*

[17] *See* Most Serious Problem: *Limited Scope of Backup Withholding Program, supra.*

[18] *See* National Taxpayer Advocate, 2003 Annual Report to Congress v, 20, 256.

on independent contractors would prove too burdensome[19] and have developed this alternate approach.

This proposal (hereinafter, "Recommendation One") differs from a universal withholding scheme in three significant respects. First, the burden would be shouldered primarily by taxpayers who have demonstrated an unwillingness to comply with their tax obligations. Second, administrative burdens on payors would be substantially less than under a universal withholding regime. Third, the proposal provides a way for payors to avoid administrative burdens entirely. Overall, Recommendation One uses market forces to drive compliance in the cash economy.

Under Recommendation One, backup withholding would only be instituted on payments to independent contractors that have demonstrated "Substantial Noncompliance," as defined by regulation, or who work in an industry or industry segment where there are significant numbers of Substantially Noncompliant independent contractors. Recommendation One would have little or no effect on compliant independent contractors.

Congress would direct the Secretary to prescribe regulations that set forth the standards for Substantial Noncompliance for purposes of the new backup withholding provisions. One possible measure of Substantial Noncompliance could be failing to file federal income tax returns or pay federal taxes for the two consecutive years immediately preceding the determination year.

Recommendation One also provides redemption for those taxpayers classified as Substantially Noncompliant. Independent contractors who demonstrate Substantial Compliance (as defined by regulation), agree to make estimated tax payments through the convenient EFTPS, and schedule regular EFTPS estimated tax payments for one year in advance, will be released from backup withholding. The IRS would then monitor these "repentant" taxpayers to make sure they were making timely EFTPS payments. If the IRS discovered that a taxpayer had missed an agreed upon EFTPS payment, the IRS would (1) immediately notify the taxpayer of the missed payment, (2) allow the taxpayer a brief window to make the payment, and (3) require regularly scheduled EFTPS estimated tax payments for a second year.

As with Substantial Noncompliance, regulations would set forth the standards for Substantial Compliance for purposes of the new backup withholding provisions. Possible measures of substantial compliance could include filing federal tax returns and paying applicable federal taxes for the two consecutive tax years immediately preceding the determination year, and using a valid TIN.

Another advantage of Recommendation One is that it would place most of the administrative compliance burdens on the independent contractor payee rather than on the business payor. Under Recommendation One, the Secretary would prescribe regula-

[19] *See* National Taxpayer Advocate 2004 Annual Report to Congress at 484.

tions creating a federal tax Compliance Certificate that an independent contractor could obtain from the IRS by providing a valid name and TIN, and by having a prior history of tax compliance.[20] Notwithstanding any other provision of Recommendation One, if an independent contractor presents a payor with a valid Compliance Certificate, backup withholding would not be instituted.

The Compliance Certificate is also the mechanism that provides the most attractive feature of Recommendation One: market driven compliance. Businesses do not want to be burdened by backup withholding on payments to independent contractors. Under current law, however, a service-recipient may not know that it is making payments to an independent contractor subject to backup withholding until the IRS notifies the service-recipient that there is a name/TIN mismatch.[21] When a payor receives such a notice from the IRS, it can incur the administrative expense to implement backup withholding, tell the independent contractor to look for work elsewhere, or ignore the backup withholding requirements and continue to pay the independent contractor on a gross basis in violation of IRC § 3406(a). None of these options are ideal for either party.

Recommendation One allows the payor to avoid these problems altogether. When an independent contractor presents a service-recipient with a valid Compliance Certificate, the Service-Recipient knows there is no risk of backup withholding on payments to that independent contractor. On the other hand, when an independent contractor does not have a valid Compliance Certificate, the service-recipient immediately knows that backup withholding on payments to this independent contractor is possible, if not likely. Moreover, if the service-recipient operates in an industry or industry segment where the IRS has determined that a significant number of Substantially Noncompliant independent contractors are operating, backup withholding will be mandatory on payments to independent contractors who do not present a valid Compliance Certificate.

Under Recommendation One, market forces will act to oblige independent contractors to operate among the ranks of the tax compliant. The easiest way for a payor to avoid a backup withholding situation is to hire only independent contractors that present a valid Compliance Certificate. It follows that independent contractors who want to work will obtain Compliance Certificates. And in order to obtain a Compliance Certificate, an independent contractor must be tax compliant. Tax compliance would become a condition of conducting business.

The Compliance Certificate element of Recommendation One is a similar, though simpler, version of the United Kingdom's "Construction Industry Scheme" (CIS). The CIS is administered by the United Kingdom's administrative tax agency, Her

[20] Independent contactors starting a new business could obtain a Compliance Certificate by providing a valid name and TIN, and agreeing to make future estimated tax payments using EFTPS.

[21] Service-recipients can check TIN validity earlier using the electronic TIN matching program. However, from October 16, 2003 to October 17, 2005, only 3,181 payors used this program. *See* Most Serious Problem: *Backup Withholding, supra.*

Majesty's Revenue & Customs (HMRC). The CIS applies only to the construction industry. Under the CIS, businesses operating in the construction industry are known as "contractors" and "subcontractors." Subcontractors perform work for and are paid by contractors. Thus, it is possible to be both a contractor and a subcontractor in the CIS. Subcontractors can obtain either a "Registration Card" or a "Tax Certificate" from HMRC. Subcontractors can receive a Registration Card simply by registering with HMRC. In order to obtain a Tax Certificate, however, the subcontractor must meet several criteria that demonstrate the subcontractor's past and current tax compliance. A subcontractor must have a valid Registration Card in order to receive any payments from a contractor. Contractors are to withhold 18 percent of payments to subcontractors with Registration Cards and pay the amount withheld to HMRC on behalf of the subcontractor. Subcontractors with valid Tax Certificates, however, are paid on a gross basis.[22]

RECOMMENDATION TWO

Amend IRC § 6302(h) to require the IRS to promote estimated tax payments through EFTPS and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.

EXAMPLE OF PROBLEM

Taxpayer is a sole proprietor performing lawn care and landscaping services as an independent contractor. Most of Taxpayer's clients are businesses, but several of her clients are personal residences. Taxpayer's business clients report payments to Taxpayer on Form 1099-MISC. Taxpayer's residential clients do not report payments to Taxpayer, and many routinely pay cash for Taxpayer's services. Taxpayer is an IRS Form 1040, Schedule C taxpayer and is required to make estimated tax payments quarterly. Taxpayer genuinely intends to pay accurate and timely estimated payments, but sometimes experiences cash flow difficulties and finds it difficult to make full estimated tax payments in a timely manner. Because Taxpayer receives several unreported payments from residential customers, she sometimes reports and pays tax on payments reported to the IRS on Form 1099 only, and then vows to be more accurate next quarter.

PRESENT LAW

Estimated Income Tax Payments

IRC § 6654 imposes a penalty on individual taxpayers who underpay estimated income taxes. In order to avoid this penalty, individual taxpayers generally must make estimated income tax payments in four installments due April 15, June 15, September 15, and January 15 of the following taxable year.[23] The estimated tax payment requirement generally applies to self-employed individuals because individuals that are employees

[22] For a detailed explanation of the CIS *see* Inland Revenue, Construction Industry Scheme, Construction Industry Series IR14/15(CIS), available at www.hmrc.gov/uk/pdfs/ir14-15cis.pdf.

[23] IRC § 6654(c).

usually have taxes withheld and deposited with the IRS throughout the year.[24]

Depository Taxes

IRC § 6656 generally imposes a penalty on employers who fail to deposit employment taxes (i.e., withheld income taxes, Federal Insurance Contribution Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes – collectively, "depository taxes") within the required time and in the proper manner. IRC § 6302(h) requires the IRS to collect at least 94 percent of depository taxes through EFTPS.[25] This "applicable required percentage" was phased in beginning at three percent for fiscal year 1994, to 94 percent for fiscal year 1999 and all fiscal years thereafter.[26]

EFTPS

IRC § 6302(h)(1) required the IRS to develop and implement an electronic fund transfer system to collect depository taxes. The IRS complied with § 6302(h)(1) by creating the Electronic Funds Transfer Payment System. EFPTS allows both individual and business taxpayers to have tax payments debited from their bank account and transferred to the U.S. Treasury. Taxpayers may enroll in EFTPS and schedule payments on the EFTPS website: www.eftps.gov. The website is accessible 24 hours a day, seven days a week. Individual taxpayers can use EFTPS to schedule automatic payments up to 365 days in advance. To enroll in EFPTS, a taxpayer must submit his or her TIN and financial institution information.[27]

REASONS FOR CHANGE

Current law requires the IRS to use EFTPS to collect at least 94 percent of depository taxes. In FY 2004, the IRS received 61 percent of all employment tax payments (and 95 percent of all employment tax dollars) through EFTPS.[28] In contrast, the IRS received less than one percent of all estimated tax payments (and less than one percent of all estimated tax dollars) through EFTPS in tax year 2004.[29] The IRS is not required to collect estimated tax payments through EFTPS.

Making estimated tax payments can be cumbersome, particularly for self-employed taxpayers who are juggling many different duties. The process of estimating income, remembering odd payment dates that do not coincide with calendar quarters, and saving

24 *See* IRC § 6654(g).

25 IRC § 6302(h)(2)(C)(ii)(V).

26 IRC § 6302(h)(2).

27 EFTPS website, www.eftpssouth.com/eftps.

28 Senior Tax Analyst, Wage and Investment Division, Customer Account Services, Submission Processing, Response to TAS Information Request (Oct. 5, 2005).

29 *Id.*

enough money to pay each quarter is not particularly "user friendly."[30]

EFTPS has the potential to alleviate some of these estimated tax payment problems because it is convenient and relatively easy to use. One key EFTPS feature that many taxpayers may find attractive is the ability to schedule automatic payments to be debited from a taxpayer's bank account. A taxpayer can use this feature to make more frequent automatic estimated payments and not worry about coming up with the required amount every quarter. Using EFTPS in this way could make estimated tax payments almost as automatic as one's monthly automobile or mortgage payment.

EXPLANATION OF RECOMMENDATION

Requiring the IRS to collect estimated tax payments through EFTPS would drive the IRS to actively promote EFTPS and make the system easier to use. The IRS currently complies with the statutory requirement to collect depository taxes through EFTPS and it stands to reason that it would also comply with a requirement to collect estimated tax payments through the same system. Because the IRS currently collects less than one percent of all estimated tax payment dollars through EFTPS, the seven-year phase-in period would allow the IRS to gradually promote EFTPS as it deemed appropriate.

RECOMMENDATION THREE

Amend IRC § 3402(p)(3) to specifically authorize voluntary withholding agreements between independent contractors and service-recipients (as defined in IRC § 6041A(a)(1)), and to specify that independent contractors who enter into voluntary agreements with payor service recipients will be treated as employees only to the extent specified in the agreement, and allow such independent contractors to continue to deduct ordinary and necessary business expenses under IRC § 162(a).

EXAMPLE OF PROBLEM

Taxpayer A is a hair stylist operating as an independent contractor who frequently performs services in B's salon. A's customers pay the salon directly and then B makes payments to A after subtracting a percentage for chair rental, general overhead expenses, and a "name use" commission. A also receives tips directly from his customers.

A approaches B and explains that he is having a difficult time maintaining accurate tax records and paying timely estimated tax payments. A asks B if she would be willing to withhold a certain percentage of each payment to A and send it to the IRS. B responds that she is not sure if such voluntary withholding arrangements are authorized, and that she is unsure how to set up such an arrangement even if one were permitted.

[30] For a detailed discussion of estimated tax payment problems *see* Most Serious Problem: *The Cash Economy, supra.*

PRESENT LAW

IRC § 3402 generally provides that employers must withhold income and FICA and FUTA taxes from wages paid to employees. IRC § 3402(p) provides for voluntary withholding agreements in certain cases that are not subject to withholding under the general rule. When a payor and payee enter into a voluntary withholding agreement under section 3402(p), payments made with respect to the agreement are treated as wage payments from an employer to an employee.

Section 3402(p)(1) provides for voluntary withholding on certain federal payments (such as Social Security benefits). Section 3402(p)(2) provides for voluntary withholding on unemployment compensation payments. Section 3402(p)(3) provides for "other voluntary withholding" agreements and authorizes the Secretary, by regulation, to provide for withholding from (1) payments from employer to employee that do not constitute wages, and (2) "any other type of payment with respect to which the Secretary finds that withholding would be appropriate under the provisions of [IRC chapter 24, Collection of Income Tax at Source]."

Section 3402(p)(3) also provides that any voluntary withholding agreement entered into under § 3402(p)(3) "shall be in such form and manner as the Secretary may by regulations prescribe." The Secretary has not prescribed regulations under § 3402(p)(3) that set forth the form and manner of voluntary withholding agreements in a non-employer/employee relationship.

IRC § 162(a)(1) generally allows taxpayers to deduct all ordinary and necessary business expenses paid or incurred during the taxable year. Self-employed taxpayers generally report these deductions on IRS Form 1040, *U.S. Individual Income Tax Return*, Schedule C, *Profit or Loss From Business (Sole Proprietorship)*.

REASONS FOR CHANGE

Even though withholding is not required on payments to independent contractors, some independent contractors may wish to enter into withholding agreements with their payors to avoid the burdens of saving and making quarterly estimated tax payments.[31] These payors may be willing to do this as a convenience to the independent contractors they pay, particularly where payors already withhold and remit employment taxes on their own employees. It is currently unclear, however, whether statutory authority exists to enter into such agreements.

IRC § 3402(p)(3) is silent on voluntary withholding agreements in the independent contractor/payor context. Section 3402 as a whole applies specifically to withholding in the employer/employee context and § 3402(p)(1) and 3402(p)(2) apply to voluntary withholding agreements in specific limited situations. Section 3402(p)(3) is the only section under which a voluntary withholding agreement between a payor and an independent

[31] *See* discussion, *supra.*

contractor would be permitted. Section 3402(p)(3)(A), however, applies specifically to remuneration for services provided by an employee to an employer. Thus, if there is any statutory authority at all for voluntary withholding agreements between a payor and an independent contractor, it would lie in § 3402(p)(3)(B), which reads:

> The Secretary is authorized by regulations to provide for withholding from any other type of payment with respect to which the Secretary finds that withholding would be appropriate under the provisions of this chapter, if the employer and employee, or the person making and the person receiving such other type of payment agree to such withholding. Such agreement shall be in such form and manner as the Secretary may by regulations prescribe.

There are at least two problems with voluntary withholding agreements between a payor and an independent contractor under § 3402(p)(3)(B). First, this section only authorizes the Secretary to provide for such agreements by regulation. There are no tax regulations providing for voluntary withholding agreements between payors and independent contractors. Second, in order to prescribe such regulations, the Secretary must find that voluntary withholding agreements between payors and independent contractors "would be appropriate under the provisions of [IRC chapter 24, Collection of Taxes at the Source]." IRC chapter 24 deals with collection of taxes at the source with respect to employees – *i.e.*, wage withholding. Independent contractors are not subject to wage withholding, thus it is questionable whether the Secretary could find voluntary withholding agreements between payors and independent contractors "appropriate" under the Code provisions dealing with employee wage withholding.

EXPLANATION OF RECOMMENDATION

Amending the Internal Revenue Code to specifically allow voluntary withholding agreements between independent contractors and their payors would clarify the application of the current statute and facilitate tax compliance. Independent contractors entering into such agreements with their payors would be relieved of the burden of making quarterly estimated tax payments. Additionally, those payors willing to incur the administrative cost of entering into voluntary withholding agreements with one independent contractor would likely offer this service to all independent contractors performing services for the payor.

Amending the Internal Revenue Code to specify that independent contractors who enter into voluntary withholding agreements with a payor service recipient are treated as employees for purposes of such agreements would only prevent employee classification for other tax purposes. Most significantly, such an amendment would allow independent contractors to continue to deduct ordinary and necessary business expenses under

IRC § 162 and continue to report these deductions on IRS Form 1040, Schedule C.[32]

RECOMMENDATION FOUR

Amend IRC § 6041A to require third-party information reporting for applicable payments to corporations, as defined in IRC § 7701(a)(3) (including corporations electing to be taxed under subchapter S of the Internal Revenue Code), with 50 or fewer shareholders.

EXAMPLE OF PROBLEM

Taxpayer A and Taxpayer B both operate window washing businesses in City. A conducts business as a sole proprietor, while B conducts business as a state Limited Liability Company that B has elected to treat as an association taxable as a corporation for federal tax purposes. B's business name contains the expression, "Inc." A and B are competitors and frequently wash windows for mutual clients. When A washes windows for a client, the client generally must report payments to A on Form 1099-MISC. When B washes windows for a client, however, the client is not required to report payments to B on Form 1099-MISC because B conducts business as a corporation.

PRESENT LAW

IRC § 6041A(a) provides that if a service-recipient engaged in a trade or business pays in the course of such trade or business, in any calendar year, an aggregate amount of $600 or more to any person for services performed by such person, then the service-recipient must file an information return reporting these payments. The applicable information return is IRS Form 1099-MISC, *Miscellaneous Income*. Most incorporated service providers, however, are exempt from Form 1099-MISC reporting.[33] In other words, under IRC § 6041A(a), service-recipients are required to report payments to individuals only. A service-recipient may treat a service provider payee as a corporation for purposes of IRC § 6041A(a) if the name of the payee contains an unambiguous expression of corporate status, *i.e.*, "Incorporated," "Inc.," "Corp.," or "P.C." (but not "Company" or "Co.").[34]

IRC § 6041A(f) requires persons receiving reportable payments under § 6041A(a) to provide to the payor, the payee's name, address and TIN. Payees generally use IRS Form

32 *See* IRS Employment Tax Handbook 104.6, Sec. 5.8.4(5) (April 21, 1999) which specifies that "statutory employees" under IRC § 3121(d)(3) are not treated as employees for purposes of deducting business expenses.

33 Treas. Reg. §§ 1.6041-3(p)(1) and 1.6049-4(c)(1)(ii)(A). Payments made by federal executive agencies to contractors organized as corporations are not exempt from Form 1099-MISC reporting. IRC § 6041A(d)(3).

34 However, a service-recipient may not treat a payee as a corporation if the service-recipient has actual knowledge that the payee is not a corporation. Treas. Reg. § 1.6049-4(c)(1)(ii)(A)(1). A service-recipient may also treat a payee as a corporation (absent actual knowledge to the contrary) if the service-recipient has the payee's corporate resolution or similar document on file; the payee provides the service-recipient with a valid IRS Form W-9 that includes a valid Employer Identification Number and a statement indicating that the payee is a domestic corporation; or the payee provides the service-recipient with a valid withholding certificate certifying that the payee is a foreign corporation. Treas. Reg. § 1.6049-4(c)(1)(ii)(A).

W-9 to provide this information. Form W-9 also requires payees to declare whether they conduct business as an individual/sole proprietor, corporation, partnership, or other business entity.

IRC § 7701(a)(3) provides that "the term 'corporation' includes associations, joint-stock companies, and insurance companies." Treas. Reg. § 301.7701-2(b) provides that for federal tax purposes, the term corporation means (among other things) a business entity organized under a federal or state corporate statute or an association as determined under Treas. Reg. § 301.7701-3. Treas. Reg. § 301.7701-3(a) provides that an "eligible entity"[35] may elect its classification for federal tax purposes. All eligible entities can elect to be classified as an association treated as a corporation for federal tax purposes.

REASONS FOR CHANGE

Taxpayers report 96 percent of income from transactions subject to information reporting.[36] The percentage of reported income decreases significantly, however, when transactions are not subject to information reporting. Under current law, an individual taxpayer can escape 1099-MISC information reporting by incorporating. This is true even if the taxpayer is performing the same services that would be subject to 1099-MISC reporting if the taxpayer were conducting business as a non corporate entity. Furthermore, a taxpayer attempting to avoid 1099-MISC reporting need only include in its business name an indication that it is doing business as a corporation in order to release the service-recipient from the IRC § 6041A reporting requirements, regardless of whether the service provider is actually incorporated.

For Form 1099-MISC information reporting purposes, there should be no distinction between taxpayers providing the same services for compensation merely because one taxpayer has incorporated (or represents that it has incorporated). There are, of course, many valid reasons for choosing to conduct business as a corporation rather than as another entity, but information reporting avoidance should not be such a reason. Corporate taxpayers that intend to comply with the tax law should have no objections to receiving a 1099-MISC for compensation for services performed, or to IRS awareness of this compensation.

EXPLANATION OF RECOMMENDATION

Amending IRC § 6041A to provide that both individual taxpayers and corporate taxpayers with 50 or fewer shareholders are subject to 1099-MISC reporting would directly reduce the cash economy by increasing transactions subject to information reporting. And because taxpayers report 96 percent of income subject to information reporting, increasing the transactions subject to such reporting will also increase reported income.

[35] An eligible entity is a business entity that is not classified as a *de facto* corporation under Treas. Reg. §§ 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8).

[36] IRS National Headquarters, Office of Research, *Interactive Tax Gap Map for Year 2001,* 22-23 (Feb. 24, 2004).

The National Taxpayer Advocate, however, recommends that 1099-MISC reporting be limited to corporations with 50 or fewer shareholders. Corporations with more than 50 shareholders are generally subject to more frequent IRS compliance activity, thus the potential for noncompliance through unreported transactions is lower. Additionally, this proposal is intended to place similarly situated taxpayers performing comparable services on the same ground with respect to 1099-MISC reporting. Larger corporations generally are not competing in the same marketplace with self-employed individuals, thus the proposal is limited to smaller corporate taxpayers.

Consistent with this recommendation, the IRS would revise Form W-9 to allow payees to declare whether they are a corporation with 50 or fewer shareholders.

3 KEY LEGISLATIVE RECOMMENDATION: TAX REFORM FOR FAMILIES: A COMMON SENSE APPROACH

PROBLEM

The Internal Revenue Code contains six provisions related to a taxpayer's family status: the Earned Income Tax Credit (EITC), Child Tax Credit (CTC), Child and Dependent Care Credit (CDCC), personal and dependency exemptions, head of household filing status, and the "separated spouse" rules of IRC § 7703(b). Each of these six provisions directly or indirectly confers a tax benefit on taxpayers who meet the various eligibility requirements. At least one of these six provisions impacts every individual income tax return filed in the United States today.

In 2004, Congress adopted a Uniform Definition of Child.[1] The uniform definition creates a single definition of a "qualifying child" for purposes of the EITC, CTC, CDCC, dependency exemption, and head of household filing status. Despite this significant step towards simplification, taxpayers claiming the different family status provisions must still navigate a labyrinth of complex rules and requirements for each provision. These rules are often counter-intuitive and therefore lead to many inadvertent errors, while providing opportunities for deliberate fraud in some instances. IRS examinations of EITC returns alone account for 48 percent of all individual income tax return examinations annually.

EXAMPLE

Taxpayer provides a home and all support for her 12-year-old cousin for the entire year. Because the child does not have a "qualifying" relationship with Taxpayer, Taxpayer cannot claim the dependency exemption for the child (and therefore is not eligible for the Child Tax Credit.) Taxpayer also cannot claim the Child and Dependent Care Credit for child care expenses because the child is not her dependent. Although Taxpayer is the only individual providing support for her cousin, Taxpayer receives food stamps and housing assistance from federal and state agencies in excess of half of the cost of maintaining the home. Moreover, Taxpayer has been estranged from her spouse for over ten years, but does not qualify as "not married" under IRC § 7703(b) because (1) she cannot claim the child as a dependent and (2) she cannot show that she provides over one-half of the cost of maintaining the household. Thus, taxpayer must file as "married filing separately" and is ineligible for the Earned Income Tax Credit.

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations to build upon the simplification achieved with the Uniform Definition of Child by further simplifying the family status provisions:

- Combine the personal and dependency exemptions, Child Tax Credit, and aspects

[1] The Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, § 201, 118 Stat. 1166 (2004).

of the EITC into a single refundable Family Credit available to all taxpayers, regardless of income. One component of the Family Credit would be available to the taxpayer (or each taxpayer, in the case of married taxpayers), and a second component of the Family Credit would be available to any taxpayer who is the "main caregiver" of a qualifying child. There would be no cap on the number of children the taxpayer could claim as "main caregiver."

- Separate the Child and Dependent Care Credit into two credits. The Child Care Credit would be available to the taxpayer who claimed the Family Credit. The Dependent Care Credit would be available to taxpayers who provided primary care for members of their extended family inside or outside of their home.
- Eliminate Head of Household filing status. Allocate the tax benefits attributable to Head of Household filing status between the Family Credit and the Dependent Care Credit.
- Replace the Earned Income Tax Credit with the Family Credit and a modified Earned Income Tax Credit. The modified Earned Income Tax Credit would provide a refundable credit to low income workers based solely on the taxpayer's earned income and would be available to workers age 18 and over for whom no one filed as the "main caregiver." Retain the investment income rule of IRC § 32(i) so that the benefits of this refundable credit go to low income taxpayers who do not have significant investments.
- Amend IRC § 7703(b) to permit taxpayers who have a legal and binding separation agreement and who live separate and apart as of the last day of the tax year to be considered "not married" for purposes of determining filing status.
- Create a separate credit for noncustodial parents of qualifying children who pay all child support obligations legally due for that tax year.

PRESENT LAW

The following section outlines the uniform definition of child as well as the eligibility requirements for the family status provisions of the Code.

Uniform Definition of Child

In the Working Families Tax Relief Act of 2004, Congress created a uniform definition of child in IRC § 152(c) of the Code. Beginning in tax year 2005, the Code defines the term "dependent" as a qualifying child or a qualifying relative.[2] The single definition of qualifying child, with certain modifications, applies for purposes of claiming the EITC, CTC, CDCC, dependency exemption, and head of household filing status.

An individual must meet four tests in order to be a qualifying child under IRC § 152(c):

[2] IRC § 152(a). If an individual does not meet the definition of a qualifying child under § 152(c), he or she may meet the definition of a qualifying relative under IRC § 152(d).

relationship,[3] age,[4] residency,[5] and support.[6] If an individual can be claimed as a qualifying child by more than one taxpayer, IRS § 152(c)(4) establishes a tie-breaker rule to determine which taxpayer can claim the child.[7]

Earned Income Tax Credit – IRC § 32

The Earned Income Tax Credit (EITC) entitles certain working low income taxpayers to claim a refundable credit of up to $4,400.[8] To qualify for the EITC, a taxpayer must meet certain general eligibility requirements related to residency,[9] filing status,[10] certain foreign benefits,[11] and status as a qualifying child of another taxpayer.[12] The tax-

[3] A qualifying child must be a taxpayer's son, daughter, stepson, stepdaughter, brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them. IRC §§ 152(c)(2), (f)(1)(A), & (f)(4). In the case of an adopted child, the child is treated as the child of the taxpayer. IRC § 152(f)(1)(B). In the case of an eligible foster child, the child is treated as the child of the taxpayer provided the child was placed with the taxpayer by an authorized placement agency or by the courts. IRC § 152(f)(1)(A)(ii), & (f)(1)(C).

[4] A qualifying child must be under the age of 19 at the end of the year, under age 24 at the end of the year and a full time student, or any age if permanently and totally disabled. IRC § 152(c)(3).

[5] A qualifying child must have the same principal place of abode as the taxpayer for more than half of the taxable year. IRC § 152(c)(1)(B). The Code makes special exceptions for temporary absences, children who were born or died during the taxable year, kidnapped children, and children of divorced or separated parents. IRC § 152(e) & (f)(6); Treas. Reg. § 1.152-1(b), & 1.152-2(a)(2)(ii).

[6] A qualifying child must not have provided more than one-half of his or her own support for the taxable year. IRC § 152(c)(1)(D).

[7] In cases where more than one taxpayer can claim an individual as a qualifying child, the taxpayers can decide who will treat the child as a qualifying child. The taxpayer who claims the qualifying child is entitled to the dependency exemption for the child, head of household filing status, the CTC, the EITC, and the CDCC (unless the rules for divorced or separated parents apply and assuming all other eligibility requirements are met). If, however, the taxpayers cannot decide who will treat the child as a qualifying child, the tie-breaker rule in IRC § 152(c)(4) determines which taxpayer can claim the child. If only one of the taxpayers claiming a child is the child's parent, then the child will be treated as the qualifying child of the parent. IRC § 152(c)(4)(A)(i). If both taxpayers claiming a child are the child's parents, then the child will be treated as the qualifying child of the parent with whom the child resided for the longest period of time during the taxable year. IRC § 152(c)(4)(B)(i). If the child lived with both parents for the same amount of time during the taxable year, then the child will be treated as the qualifying child of the parent with the highest adjusted gross income. IRC § 152(c)(4)(B)(ii). If neither of the taxpayers claiming a child is the child's parent, then the child is treated as the qualifying child of the taxpayer with the highest adjusted gross income for the taxable year. IRC § 152(c)(4)(A)(ii).

[8] IRC § 32. The maximum amount of the credit is available to a taxpayer with two or more qualifying children. For tax years beginning in 2005, the maximum credit available for a taxpayer with one qualifying child is $2,662 and for a taxpayer with no qualifying children is $399. Rev. Proc. 2004-71, 2004-50 I.R.B. 970. The actual amount of the EITC varies depending on the earned income of the taxpayer.

[9] A taxpayer is not eligible for the EITC if he or she is a nonresident alien for any portion of the taxable year, unless the taxpayer files a joint return with a spouse who is a United States citizen or resident alien. IRC § 32(c)(1)(D).

[10] A taxpayer is not eligible for the EITC if he or she is filing married filing separately. IRC § 32(d).

[11] A taxpayer is not eligible for the EITC if he or she claims a foreign earned income exclusion or deducts or excludes a foreign housing amount. IRC § 32(c)(1)(C).

[12] A taxpayer is not eligible for the EITC if he or she is the qualifying child of another taxpayer. IRC § 32(c)(1)(B).

payer must also have a taxpayer identification number,[13] earned income,[14] and limited amounts of income.[15] The EITC is available to taxpayers either with or without a qualifying child. Taxpayers wishing to claim the EITC without a qualifying child must meet additional eligibility requirements.[16] To be considered a qualifying child for the EITC, an individual must meet the definition of qualifying child in § 152(c),[17] they must be unmarried at the end of the taxable year (unless the taxpayer is entitled to a deduction under § 151 for the married individual),[18] and their principal place of abode must be in the United States.[19]

Child Tax Credit – IRC § 24

The Child Tax Credit (CTC) entitles a taxpayer to claim a credit of up to $1,000 for each qualifying child, as defined in § 152(c), who is under age 17.[20] The amount of the credit is applied to any taxes due and in some instances, is refundable.[21]

Child and Dependent Care Credit – IRC § 21

The Child and Dependent Care Credit (CDCC) entitles a taxpayer to claim a credit for expenses incurred so the taxpayer (and spouse, if married) could work or look for work.[22] To qualify for the credit, a taxpayer must maintain a home for one or more

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13 A taxpayer cannot claim the EITC if he or she does not have a valid social security number. IRC § 32(c)(1)(E).

14 A taxpayer cannot claim the EITC unless he or she has earned income. IRC § 32(a).

15 A taxpayer's earned income, adjusted gross income, and investment income must all be within limits established annually. IRC § 32(a)(2) & (j).

16 A taxpayer is not eligible to claim the EITC without a qualifying child unless the taxpayer's principal place of abode is in the United States for more than half the taxable year, the taxpayer is at least 25 but under age 65 at the close of the taxable year, and the taxpayer does not qualify as a dependent of another taxpayer under § 151 for the taxable year. IRC § 32(c)(1)(A)(ii).

17 IRC § 32(c)(3)(A). For purposes of the EITC, a qualifying child under § 152(c) is determined without regard to § 152(c)(1)(D) (requiring that a qualifying child not have provided over one half of his or her own support for the taxable year) and § 152(e) (describing special rules for divorced parents). IRC § 32(c)(3)(A).

18 IRC § 32(c)(3)(B).

19 IRC § 32(c)(3)(C).

20 IRC § 24(a), & (c). The amount of the Child Tax Credit is reduced by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified adjusted gross income exceeds the threshold amount ($110,000 in the case of a joint return, $75,000 in the case of a taxpayer who is not married, and $55,000 in the case of a married taxpayer filing separately). IRC § 24(b)(1) & (2).

21 IRC § 24(d).

22 IRC § 21. The amount of the credit is a percentage, based on adjusted gross income, of the amount of employment-related expenses paid by the taxpayer during the taxable year. IRC § 21(a)(2), &(c). A taxpayer may claim a credit of up to 35 percent of child and dependent care expenses paid during a taxable year, up to a maximum of $3,000 for a taxpayer with one qualifying individual or $6,000 for a taxpayer with two or more qualifying individuals. IRC § 21(a), & (2) (c). This percentage is reduced one percentage point for every $2,000 (or fraction thereof) by which the taxpayer's adjusted gross income exceeds $15,000. IRC § 21(a)(2).
A taxpayer may not claim this credit based on household or care expenses paid to a relative who is a dependent of the taxpayer or the taxpayer's child who is not over 19. IRC § 21(e)(6).

qualified individuals.[23] Additionally, a taxpayer must have earned income[24] and must meet certain filing status requirements.[25]

Dependency Exemption – IRC § 151

The dependency exemption entitles a taxpayer to claim an additional exemption for each dependent who is a qualifying child or qualifying relative of the taxpayer, as defined in IRC § 152. A qualifying child must be under the age of 19 at the close of the taxable year, under 24 and a full-time student, or be permanently and totally disabled.[26]

Head of Household – IRC § 2(b)

Head of household filing status entitles a taxpayer to a larger standard deduction and a more favorable tax rate than a taxpayer filing single or married filing separately.[27] To qualify as head of household, a taxpayer must be unmarried or "considered unmarried" at the end of the taxable year.[28] For more than half of the taxable year, a taxpayer must maintain, as the taxpayer's home, a household that is the principal place of abode of a qualifying child[29] or a qualifying relative as defined under IRC § 152(d)(2)(A)-(F), for whom the taxpayer can claim a dependency exemption under IRC § 151.[30] Additionally, the taxpayer can qualify for head of household status if they maintain a household which is the principal place of abode of the taxpayer's mother or father for whom the taxpayer can claim a dependency exemption under IRC § 151.[31]

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23 IRC § 21(a)(1). A qualified individual is a dependent, defined as a "qualifying child" under § 152(a)(1) who is under the age of 13, a dependent who is physically or mentally incapable of caring for himself or herself, or a spouse of the taxpayer who is physically or mentally incapable of caring for himself or herself. IRC § 21(b)(1). Special rules apply for children of divorced or separated parents, allowing only the custodial parent to claim the CTC even if the noncustodial parent claims the child as a dependent under the rules of § 152(e). IRC § 21(e)(5).

24 IRC § 21(d)(1). Special rules apply for calculating earned income with regard to the spouse of a taxpayer who is a student or who is physically or mentally unable to care for himself. IRC § 21(d)(2).

25 IRC § 21(e)(2).

26 IRC § 151(c)(1) 152(a) & (c). For tax year 2005, the dependency exemption amount is $3,200. Rev. Proc. 2004-71, 2004-50 I.R.B. 970.

27 For tax year 2005, the standard deduction for head of household is $7,300. Rev. Proc. 2004-71, 2004-50 I.R.B. 970.

28 IRC § 2(b). A taxpayer whose spouse died during the taxable year is considered married for that year. IRC § 2(b)(2)(C). A taxpayer is not considered as married if he or she is legally separated from his or her spouse under a decree of divorce or separate maintenance or if his or her spouse is a nonresident alien at any time during the taxable year. IRC §§ 2(b)(2)(A), (B). A taxpayer is also considered unmarried if he or she is treated as unmarried under the provisions of § 7703. IRC § 2(c).

29 IRC § 2(b)(1)(A)(i). IRC § 2(b)(1)(A)(i) contains specific rules for married children. Additionally, for purposes of head of household, a qualifying child is determined under the rules of § 152(c) but without regard to the rules for divorced or separated parents under § 152(e). IRC § 2(b)(1)(A)(i).

30 IRC § 2(b)(1)(A)(ii). A taxpayer is considered as maintaining a household if the taxpayer provides over half of the cost of maintaining the household for the taxable year. IRC § 2(b).

31 IRC § 2(b)(1)(B).

Separated Spouse Rule Under IRC § 7703(b)

Under IRC § 7703(a), the determination of whether an individual is married is generally made as of the last day of the individual's tax year. As an exception to this rule, IRC § 7703(b) provides that certain married persons who are living apart from their spouses may be treated as unmarried. A married taxpayer (as determined under the general rule of IRC § 7703(a)) living apart with a dependent child will qualify as an unmarried person if each of the following conditions is met:

- The taxpayer must file a separate tax return;
- The taxpayer must pay more than half the cost of maintaining his or her household for the tax year;
- The taxpayer's spouse must not be a member of the household during the last six months of the year; and
- The household must, for more than six months of the year, be the principal home of the taxpayer's child (as defined in IRC § 152(f)(1)) for whom the taxpayer can claim a dependency exemption, or could claim such an exemption except for the special rules for divorced parents under IRC § 152(e).

REASONS FOR CHANGE

As demonstrated in the preceding Present Law section, the current family status provisions, which affect virtually every individual taxpayer, impose a complex web of eligibility requirements. This bewildering array of family status provisions leads to inadvertent noncompliance and, in some instances, provides opportunities for taxpayers to game the tax system. Moreover, because of congressional and administrative concern about noncompliance with respect to the Earned Income Tax Credit, the IRS disproportionately audits returns including EITC claims.[32] Because of the provision's complex and often counter-intuitive eligibility rules, these audits impose high compliance burdens on a population least able to meet such demands.

The current family status provisions provide little recognition of the fact that many children today live in split households and that noncustodial parents who maintain a second household have a reduced ability to pay taxes. Further, the current rules that permit custodial parents to release the dependency exemption (and Child Tax Credit) to the noncustodial parent are fraught with complexity and permit family law courts to arbitrate claims for and to award federal tax benefits.

The EITC, as currently structured, provides little assistance to the working poor who do not have qualifying children and who are under 25 and over 65, despite 65 percent of

[32] In FY 2004, the IRS examined 1,007,874 individual tax returns. Of the returns examined, 48 percent – or 487,461 returns – contained EITC claims. *IRS Data Book 2004*, Publication 55B (rev. 3-2005), Table 10, Examination Coverage. In comparison, only 17 percent of all individual returns filed contained an EITC claim. Statistics of Income, Tax Year 2002 Complete Data, Table 4. For a detailed discussion of IRS EITC examinations, *see* Most Serious Problem: EITC Examination Issues, *supra*.

people between the ages of 20 and 24 who are employed in the civilian workforce, and 36 percent of males and 26 percent of females who are still employed at age 65.[33]

Over the years, many learned tax theorists, practitioners, and scholars have proposed reforms of the Code's family status provisions. Most recently, the President's Advisory Panel on Federal Tax Reform proposed replacing the standard deduction, personal exemptions, Child Tax Credit, and head of household filing status with a Family Credit and the Earned Income Tax Credit and the refundable Child Tax Credit with a Work Credit. Britain revamped its delivery of family and work benefits over a period of seven years and is now providing benefits through its tax system in the form of a Child Tax Credit and a Working Tax Credit.

The IRS is conducting exciting research about the Earned Income Tax Credit and using the information to better understand the taxpayer population eligible for the EITC. For example, the 2002 joint Treasury-IRS EITC Task Force identified that the IRS was able to systemically verify relationships between taxpayer and child in 80 percent of the tax returns claiming EITC. Moreover, the IRS was able to be reasonably confident, based on its own and other studies, that where the child was claimed by the mother or on a married-filing-jointly return, the child actually did reside with the claimant for more than one-half the year. This population accounted for 80 percent of EITC tax returns.

The IRS is also learning that where the IRS cannot systemically verify certain eligibility requirements, taxpayers may not be opposed to "certifying" eligibility in advance. The IRS's recent report to Congress about its EITC Certification Initiative notes that

> [t]axpayers also appear not to object to the concept of proving eligibility prior to receiving the EITC. About 64 percent of the test group and 59 percent of the control group taxpayers thought that taxpayers should be required to prove they meet the EITC requirements before they received the EITC. About 30 percent of the test group answered no to this question, as did 36 percent of the control group.[34]

This confluence of the enactment of the Uniform Definition of Child, IRS research initiatives, and thoughtful reform proposals, create an excellent environment in which fundamental and positive change can occur. Once goal for this reform should be to relieve the IRS and taxpayers from the tax agency's poking around into taxpayers' personal lives in a very intrusive fashion and focusing disproportionately on the private lives of the working poor.

33 U.S. Census Bureau, *Employment Status 2000*, August 2003. Economic Policy Institute, *Snapshot*, June 15, 2005.

34 Internal Revenue Service, *IRS Earned Income Tax Credit (EITC) Initiative, Final Report to Congress*, 43 (October 2005).

EXPLANATION OF RECOMMENDATIONS

Our proposals attempt to redefine the eligibility rules for the Code's family status provisions in a way that allows the tax system to get to "yes" in most instances without imposing intolerable compliance burdens on taxpayers. They build on the IRS's current technology and revenue protection strategies, and establishes eligibility requirements based on our ability to verify those requirements either systemically or with minimal burden to the taxpayer. Thus, the proposals reverse the current structure of the family tax provisions, which establishes complex and rigid eligibility tests and then makes taxpayers tie themselves up in knots in order to prove to the IRS that they are eligible.

In making our proposals, we do not flesh out all relevant rules, nor do we take a position on the distribution of family or work benefits. We expect that Congress will hear from many sources on these very points, and indeed, there are many studies to guide one in making these decisions.[35] However, as Congress works through reform of these family tax provisions, it must keep in mind that in the family status area, a trade off exists between rigidity, complexity, and taxpayer burden on the one hand, and flexibility, simplicity, and taxpayer compliance on the other. A multitude of rules that focus on the perceived abuse-of-the-day ends up creating traps and burdens for *all* taxpayers.

By combining several provisions into one Family Credit, we eliminate complex and often contradictory eligibility requirements still extant in the Code today. The definition of "main caregiver" should include aspects of the Uniform Definition of Child but also permit greater flexibility in satisfying the requirements. Thus, for a taxpayer to be eligible for the Family Credit, the taxpayer must live in the United States for more than half the year and be the "main caregiver" for a child. That child must be younger than 19 (24 if a full-time student),[36] or any age if disabled. The "main caregiver" requirement can be satisfied by the taxpayer and the child having a primary relationship, or by the "main caregiver" providing the principal residence for the child or otherwise providing the principal financial support for the child.

Where there are no competing claims for the child, the IRS would accept the claim, providing, of course there were no indications that the taxpayer was ineligible to claim the child as a main caregiver. Where there are competing claims, Congress could establish a

[35] *See, e.g.*, The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (November 2005); Adam Carasso, Jeffrey Rohaly, and C. Eugene Steuerle, A Unified Children's Tax Credit, National Tax Association Proceedings (May 15, 2005), available at http://www.urban.org/uploadedPDF/1000790.pdf; Lawrence Zelenak, *Redesigning the Earned Income Tax Credit as a Family-Sized Adjustment to the Minimum Wage*, 57 Tax Law Rev. 301 (Spring 2004); Max B. Sawicky, Robert Cherry and Robert Denk, The Next Tax Reform: Advancing Benefits for Children, Economic Policy Institute (2002).

[36] We retain the current law eligibility provision for students under age 24 who attend institutions of higher learning on a full-time basis. Although Congress could provide assistance to families with older children who are students as a separate education tax credit, many families will incur costs even where students receive scholarship or other financial assistance. Moreover, it makes little sense to impose separate eligibility requirements and tests on taxpayers where the children are still part of the family unit, as those additional requirements or tests add to complexity.

hierarchy, as with the current EITC tie-breaker rule.

The Family Credit includes a basic credit for the taxpayer, another credit for the taxpayer's spouse (although under our proposal for repealing Joint and Several Liability,[37] each spouse would claim his or her own credit), and a credit for each qualified child for whom the taxpayer is the "main caregiver."

In most instances, the IRS would be able to verify eligibility for the family credit through its current databases. Where the IRS could not systemically verify eligibility, taxpayers could either apply to the IRS in advance and "certify" their eligibility, or submit their claims with their tax returns. Under either method, the IRS would retain the record of "main caregiver" status for that taxpayer until a competing claim or other new information indicated a shift in eligibility. Thus, the vast majority of taxpayers would not have to certify at all, and all but a very few would have to certify only once.

Since there is no cap on the number of children who can be claimed by a taxpayer and the Family Credit is refundable at lower income levels but also available to taxpayers with higher incomes, taxpayers will not find themselves having to "lend" or "borrow" children. Where there are no "dueling" claims for children, the IRS will pay out the Qualifying Child component of the credit so long as the IRS verifies that the child exists and is of the requisite age (via the Social Security database). Taxpayers in non-traditional households can still be eligible for the credit but would have to certify, either in advance of or at the time of filing.

The new credit for noncustodial parents who pay their entire child support obligations for the calendar year addresses the fundamental concept of taxing persons based on their ability to pay. The credit will also reduce many of the current competing claims for dependency exemptions, child credit, head of household filing status, and EITC. Taxpayers can demonstrate child support payment compliance through affidavits from the payee or from the appropriate child support enforcement agency.

Repeal of head of household filing status eliminates some tax benefits for persons maintaining a home for parents or other persons who are not the taxpayer's child. Thus, we propose to allocate some of the tax benefits associated with head of household filing status to the new Dependent Care Credit, which would be available to taxpayers who provide primary care for members of their extended family either inside or outside of their homes.

Taxpayers will be eligible for the modified Earned Income Tax Credit as a single earner or a married household.[38] Because the presence or absence of a child is not an eligibility factor, the IRS can check eligibility on the basis of income reporting. Congress

[37] *See* Key Legislative Recommendation: *Another Marriage Penalty: Taxing the Wrong Spouse, infra.*

[38] The modified EITC would retain the phase-in/plateau/phase-out structure of the current EITC so that it is targeted to low income workers, although the precise break points might change based on policymakers' distribution decisions.

should establish a goal for the IRS and Social Security to work together so the IRS can screen all EITC claims against third party documents for income eligibility by May 1 of each year and issue checks by July 1. The financial impact of this delay on low income taxpayers will be offset in part by their receiving the refundable portion of the Family Credit immediately (*i.e.*, no delay once eligibility is satisfied) and the availability of the Advanced Earned Income Tax Credit. Congress should require the Secretary of the Treasury to deliver this credit to taxpayers electronically, through low-cost bank accounts, thereby eliminating the need for taxpayers to obtain expensive Refund Anticipation Loans (RALs).[39]

The net effect of these proposals is to take the IRS out of the business of looking intrusively into taxpayers' family situations. The tax provisions relating to family status will be subject to common sense rules that recognize the variety of family circumstances in the United States. While there are winners and losers (as with all reform proposals), the net effect of these proposals is to eliminate conflicting, counter-intuitive eligibility rules, remove the IRS from custody and divorce contests, and focus much of its compliance work in this area on data that can be verified through third-party reporting, other government and private databases, and in a relatively few instances, from the taxpayer him or herself, with a minimum of taxpayer burden.

[39] *See* Most Serious Problem: *Refund Anticipation Loans: Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives, supra.*

4 KEY LEGISLATIVE RECOMMENDATION: ANOTHER MARRIAGE PENALTY: TAXING THE WRONG SPOUSE

PROBLEM

The federal income tax liabilities of married persons are often imposed on or collected from a spouse who did not earn the income subject to tax, *i.e.*, the "wrong" spouse. Each taxpayer who files a joint return with his or her spouse is "jointly and severally" liable for tax on all of the couple's income, regardless of who earned or spent it.[1] The only way to avoid joint and several liability is to file separately. However, married individuals filing separately lose many of the benefits they would otherwise be entitled to receive. Even if married taxpayers file separately, each is generally subject to tax on one-half of any "community income," including income earned by his or her spouse.[2]

Recognizing that it is inequitable to hold one spouse liable for tax on the other spouse's income, at least in cases where he or she does not know about the income or significantly benefit from it, Congress enacted relief rules.[3] These rules reallocate income (and other items) between spouses or relieve one spouse of liability for taxes attributable to the other. However, the relief rules are sometimes overly narrow, complex, costly for the IRS to administer, and burdensome for taxpayers.[4] Further, even if these rules apply so that an "innocent spouse" is not liable for the other spouse's tax, the IRS may be able collect the other spouse's tax liability from the innocent spouse in community property states.[5]

EXAMPLES

Example 1: Community Income. A married couple "domiciled" in a community property state separate in February, but each spouse's earnings continue to be community property under state law.[6] The husband earns more than the wife and receives a significant bonus in December of the same year. The wife erroneously includes on her return all of the income she earned and omits all of the income her husband earned, including the bonus. The IRS audits her return and determines that she is liable for tax on one-half of the community income, including the husband's bonus. She does not qualify for "traditional" or "equitable" community property relief under IRC § 66(c) because

[1] IRC § 6013(d)(3). "Joint and several liability" means that the IRS may collect 100 percent of the liability from either spouse.

[2] *See Poe v. Seaborn*, 282 US 101 (1930). Married taxpayers in community property states have "community income" under state law. *Id.* However, various exceptions override community property rules, as discussed below.

[3] *See* IRC §§ 6015 (joint and several liability relief); 66 (community property relief).

[4] For further discussion, *see* Most Serious Problem: *Innocent Spouse Claims, supra.*

[5] *See, e.g., Medaris v. U.S.*, 884 F.2d 832 (5th Cir. 1989).

[6] Which state's law applies depends on a person's "domicile." *See, e.g., U.S. v. Mitchell*, 403 U.S. 190 (1971); IRM § 25.18.1.2.1 (Feb. 15, 2005). A domicile is the permanent legal home the taxpayer intends to use for an indefinite or unlimited period, and to which, when absent, he or she intends to return. *Id.* Domicile is not always where the taxpayer presently lives or resides. *Id.*

she cannot establish that she did not know or have reason to know about her husband's earnings. However, if she were domiciled in a common law state, she would include on her return 100 percent of her earnings and none of his.

Example 2: Joint and Several Liability. A husband is a self-employed carpenter. The wife needs to file a joint return to obtain the earned income tax credit to provide for her children. The husband conceals some of his income from the wife and does not report it on the joint return. Three years later the IRS assesses additional tax associated with the husband's unreported income. The husband ignores the assessment and conceals all of the collection notices sent to the couple's home, including Letter 1058(c), *Notice of Intent to Levy and Notice of Your Right to a Hearing*, addressed to the wife.[7] Three years after the IRS sends the Letter 1058(c), the wife learns of the understatement and separates from the husband.[8] She is not eligible for "innocent spouse" relief under IRC § 6015 because more than two years have passed since the IRS began collection activities with respect to her.[9]

Example 3: Collection of Community Property. Assume the same facts as Example 1, except that the wife establishes that she did not know or have reason to know about the husband's bonus and obtains community property relief under IRC § 66(c). As a result, the husband is subject to tax on the entire bonus (and the wife is not), but he is unwilling or unable to satisfy the liability. If the couple is domiciled in Wisconsin, a community property state, the IRS can garnish up to 100 percent of the wife's wages to collect the husband's liability.[10] If the couple is domiciled in a common law state the IRS can not garnish any of the wife's wages to collect the husband's liability.[11]

RECOMMENDATIONS

The National Taxpayer Advocate's recommendations are as follows:

- Eliminate joint and several liability for joint filers.[12] Require married taxpayers to file a split-column tax return, which identifies separate items of income, deduc-

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[7] Letter 1058(c) is usually sent via certified mail, return receipt requested. See IRM § 5.19.8.4 (Oct. 1, 2002). Even if sent via certified mail, the U.S. Postal Service will deliver it to anyone who receives mail at the address unless the sender pays an additional $3.50 for Restricted Delivery. *See* http://www.usps.com/customersguide/dmm100.htm#1 (last visited Dec. 12, 2005).

[8] An "understatement" of tax or "deficiency" is generally the difference between the amount of tax that the IRS determines should have been shown on the return and the amount actually shown on the return. See Form 8857, *Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief)* (Feb. 2004).

[9] *See* IRC § 6015(b)(1)(E), (c)(3)(B); Treas. Reg. § 1.6015-5(b)(1); Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.01(3) and § 5.

[10] *See* Wis. Stat. § 766.55(2)(b) (West 2005) (obligations incurred by either spouse in the interest of the marriage or the family may be satisfied from all marital (community) property); Wis. Stat. § 766.55(1) (West 2005) (obligations incurred by a spouse during marriage presumed incurred in the interest of the marriage or the family); Wis. Stat. § 766.31(4) (West 2005) (income earned by either spouse during marriage is marital (community) property, even if the spouses are separated).

[11] *See, e.g., United States v. Craft*, 535 U.S. 274 (2002).

[12] Revise IRC § 6013(d), which imposes joint and several liability.

tion, credit, and payment, similar to the combined return adopted by a number of states.[13]

- Repeal the rule of *Poe v. Seaborn*[14] that each spouse is taxed on one-half of any community income. Apply the federal rules for allocating a nonresident alien's community income to all couples, with slight modification.[15]
- Require the IRS to exhaust efforts to collect against assets under the liable spouse's control before collecting against assets under the nonliable spouse's control, unless such efforts would be futile.[16]

These recommendations will tax married persons more fairly by aligning each person's tax with his or her individual ability to pay and by minimizing the impact of state property and collection rules, where these rules subject taxpayers to different amounts of federal income tax just because they are in different states. The recommendations will also significantly reduce complexity. If adopted, the following complex processes could be eliminated or substantially simplified: "innocent spouse" relief, community property relief, "injured spouse" relief,[17] and numerous Code provisions that override community property rules in an *ad hoc* fashion.

[13] The National Taxpayer Advocate made a similar proposal in 2001. See National Taxpayer Advocate 2001 Annual Report to Congress 128. The American Bar Association (ABA) and the American Institute of Certified Public Accountants (AICPA) also support eliminating joint and several tax liability. *See* ABA Recommendation #1992-12, 13-4 Newsletter 13 1995-2, *available at* http://www.abanet.org/tax/pubs/aba.pdf (the "1995 ABA Recommendation"); American Bar Association Section of Taxation Domestic Relations Committee, *Comments on Liability of Divorced Spouses for Tax Deficiencies on Previously Filed Joint Returns*, 50 Tax Law. 395 (Winter 1997) (the "1997 ABA Comments"); Testimony of David Lifson, Vice Chair Tax Executive Committee American Institute of Certified Public Accountants Before the Committee on Ways and Means, Hearing on the Marriage Penalty (Jan. 28, 1998) (including AICPA's Comments on Notice 96-19, hereinafter "AICPA Comments"). For ease of administration, our proposal would: (1) sever joint liability when the IRS first asserts an underpayment or deficiency against a joint filer; (2) disallow separate refunds of voluntary payments made before the IRS asserts an understatement or underpayment that would otherwise be paid solely as a result of severing the joint liability; and (3) allocate liability for deficiencies on an item-by-item basis. These modifications are similar to those described in the 1997 ABA Comments.

[14] *Poe v. Seaborn*, 282 U.S. 101 (1930).

[15] *See* IRC § 879(a). Our proposal would allocate "other income" to the spouse with control of the income.

[16] This requirement would mirror what is required before the IRS may collect on a transferee liability under current law. *See, e.g., U.S. v. Russell*, 241 F.2d 879 (1st Cir.1957); IRM § 4.10.13.3 (Mar. 30, 2005).

[17] The IRS may offset a joint refund to collect either spouse's separate liabilities unless the nonliable spouse obtains "injured spouse" relief. *See, e.g.*, IRC § 6402; Treas. Reg. § 301.6402-6(i).

PRESENT LAW

The following table illustrates how present law can tax the wrong spouse, and identifies the relief rules, if any, that are intended to address the problem on a case-by-case basis:

TABLE 2.4.1, SUMMARY OF PRESENT LAWS THAT TAX THE WRONG SPOUSE AND POTENTIAL RELIEF RULES BY TAXPAYER LOCATION AND FILING STATUS

Location/Law	Community Property Law States		Common Law States		Federal Relief Rules	
Filing Status	Separate	Joint	Separate	Joint	Separate	Joint
Taxed on income earned by spouse?	Yes	Yes	No	Yes	§ 66	§ 6015
Liable for spouse's tax?	No	Yes	No	Yes	No relief	§ 6015
Earnings collected for spouse's tax?	Yes	Yes	No	Yes	No relief	No relief

Community Income

General Rule

A taxpayer's federal taxable income depends on state property law. In common law states, income is generally taxed to the spouse who earns it or holds title to the property generating the income.[18] In contrast, in community property states, income earned during marriage is generally taxed one-half to each spouse, *i.e.*, the spouses "split" marital income for federal income tax purpose.[19] Nine states have community property laws, including: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.[20]

Lack of Uniformity

Because federal taxable income is determined by reference to state law, taxpayers in common law states are subject to tax on different amounts of income when compared to similarly situated taxpayers in community property states. In addition, similarly situated taxpayers in different community property states are subject to tax on different amounts of income.

DIFFERENT PERIODS DURING WHICH INCOME IS COMMUNITY PROPERTY. In general, only income earned during marriage is community property. However, the states have varying rules about the events that begin and end the period during which earnings will be community property. Some states recognize a "common law" marriage as beginning this period, while others do not.[21] In Wisconsin, this period terminates on the day the

18 *See, e.g., Lucas v. Earl*, 281 U.S. 111 (1930).

19 *See Poe v. Seaborn*, 282 US 101 (1930).

20 IRM Exhibit § 25.18.1-1 (Feb. 15, 2005). Complexities may arise if several jurisdictions are involved. *See, e.g., Jones v. Weaver*, 123 F.2d 403 (9th Cir. 1942); *Commissioner v. Cavanagh*, 125 F.2d 366 (9th Cir. 1942).

21 *See* IRM Exhibit § 25.18.1-1 (Feb. 15 2005). A common law marriage is generally a legal marriage arising without a legal ceremony. Texas, a community property state, recognizes common law marriage. *See, e.g., Schmidt v. Commissioner*, T.C. Memo. 1981-38.

court enters a valid decree of divorce or legal separation.[22] In California, however, it terminates on the date the spouses separate if they both intend to permanently end the marriage.[23]

EARNINGS ON SEPARATE PROPERTY. Another difference among community property states is the treatment of earnings from separate property. In Wisconsin, earnings from separate property (called individual property) during the marriage are community property.[24] In California, however, earnings from separate property generally remain separate property.[25] The following example illustrates these differences.

Example 4: Variations in Federal Taxable Income by State. A married couple separate on March 31 with the intention to permanently end the marriage, but are unable to obtain a legal separation or divorce during the year. During the year the husband (H) earns $2,000 in wages each month. The wife (W) earns $5,000 in wages and $4,000 in interest income on separately owned CDs each month. W also receives a $10,000 bonus on December 1 of the same year. H and W do not commingle separate property, and file separate tax returns for the year.[26] The following table illustrates how H's and W's taxable income, tax liability, and effective tax rates would change under various state laws using 2005 tax rates.

TABLE 2.4.2, FEDERAL TAXABLE INCOME, LIABILITY AND EFFECTIVE TAX RATE BY STATE

	Illinois (common law)		California (community)		Wisconsin (community)	
	W	H	W	H	W	H
H's Wages	—	$24,000	$3,000	$21,000	$12,000	$12,000
W's Wages	$60,000	—	$52,500	$7,500	$30,000	$30,000
W's Bonus	$10,000	—	$10,000	—	$5,000	$5,000
W's Interest	$48,000	—	$48,000	—	$24,000	$24,000
Taxable Income[27]	**$118,000**	**$24,000**	**$113,500**	**$28,500**	**$71,000**	**$71,000**
Tax Liability	**$26,678**	**$2,009**	**$25,129**	**$2,684**	**$12,457**	**$12,457**
Effective Rate[28]	23%	8%	21%	11%	11%	52%

22 *See* Wis. Stat. § 766.55(2m) (West 2005).

23 *See* Cal. Fam. Code § 910 (West 2005); *In re McIntyre*, 222 F.3d 655 (9th Cir. 2000); *In re the Marriage of Von Der Nuell*, 28 Cal. Rptr. 2d 447 (Mar. 21, 1994); IRM § 25.18.1.2.3 (Feb. 15, 2005).

24 *See* Wis. Stat. § 766.01(10) (West 2005). *See also, Lloyd v. Lloyd*, 487 N.W.2d 647 (Wis. Ct. App. 1992); Rev. Rul. 2004-71, 2004-30 I.R.B. 74.

25 *See* Cal. Fam. Code § 770 (West 2005). *See also* Rev. Rul. 2004-72, 2004-30 I.R.B. 77.

26 Because they are married at the end of the year they must use a "married" filing status. *See* IRC § 7703(a)(1) (determining marital status as of the last day of the year).

27 The term "taxable income" refers to income subject to federal income tax and corresponds to "total income" shown on Form 1040.

28 For purposes of calculating effective tax rate (liability/income), we use the common law definition of income.

Although H only earned $24,000, depending on which state law applies, his taxable income could be as high as $71,000, producing a tax liability of $12,457, which represents 52 percent of his earnings. Similarly, although W earned wages and interest of $118,000, her taxable income could be as low as $71,000, producing the same tax liability of only $12,457, which represents just 11 percent of her earnings and interest income.

Community Property Exceptions

Although a taxpayer's federal taxable income generally depends on state property law, the Internal Revenue Code contains a patchwork of *ad hoc* exceptions. These exceptions generally ignore state community property laws for federal income tax purposes, discussed below.

PHYSICALLY AND ECONOMICALLY SEPARATE FOR ONE YEAR. Any community income is allocated for federal income tax purposes in accordance with IRC § 879 (discussed below) rather than local community property laws if:

- The couple lived apart at all times during the year;
- The couple did not file a joint return;
- At least one spouse had "earned income"[29] which was community income; and
- No portion of such earned income was transferred, directly or indirectly, between the spouses during the year.[30]

Thus, this exception does not apply: (1) in the year of the separation, (2) if one spouse makes one or more payments to the other out of earned income, or (3) if neither spouse has earned income from personal services.

When this exception applies, community income is allocated under IRC § 879 similar to the way income is allocated in common law states, as follows:

- Earned income from personal services is allocated to the spouse who rendered the services;[31]
- Trade or business income is allocated to the spouse carrying on the trade or business, or if the trade or business is jointly operated, on the basis of their respective distributive shares;"[32]
- Partnership income is allocated to the spouse who is the partner;[33]
- Income from the separate property of one spouse is allocated to that spouse; and[34]

[29] "Earned income" is generally income attributable to personal services. *See* IRC § 911(b).

[30] *See* IRC § 66(a). Payments are presumed to be made out of earned income. *See* Treas. Reg. § 1.66-2(c).

[31] IRC § 879(a)(1); Treas. Reg. § 1.879-1(a)(2); IRC § 911(d)(2).

[32] IRC § 879(a)(2); IRC § 1402(a)(5).

[33] IRC § 879(a)(2); Treas. Reg. § 1.879-1(a)(4); IRC § 1402(a)(5).

[34] IRC § 879(a)(3); Treas. Reg. § 1.879-1(a)(5).

- Other income – consisting of dividends, interest, rents, royalties, or gains, from community property or of the earnings of unemancipated minor children -- is allocated in accordance with local law.[35]

NONRESIDENT ALIENS. Any community income of married taxpayers one or both of whom are nonresident aliens is allocated in accordance with IRC § 879 rather than local community property laws, absent an election.[36]

SELF-EMPLOYMENT AND OTHER TAXES. Even if a taxpayer does not qualify for any exceptions to the community property rules, various Code provisions disregard the community property income allocation rules. For example, the rules relating to the following provisions apply without regard to community property law:

- Self-employment taxes,
- Relief from joint and several liability (innocent spouse relief),
- Earned income tax credit,
- Individual Retirement Accounts (IRAs),
- Employee benefit plans,
- Deferred compensation plans,
- Archer Medical Savings Accounts,
- Health savings accounts,
- Methods of accounting, and
- Coverdell Education Savings Accounts.[37]

Community Property Relief

Those married taxpayers who are subject to community property income allocation rules and file a separate return (or no return), may request two types of relief from its operation – "traditional relief" or "equitable relief."[38]

TRADITIONAL RELIEF. Traditional relief may be available to reallocate an item of community income from the "requesting" spouse to the "nonrequesting" spouse if the requesting spouse:

[35] IRC § 879(a)(4); Treas. Reg. § 1.879-1(a)(6). Our proposal would adjust this allocation rule.

[36] *See* IRC § 879(a).

[37] *See, e.g.*, IRC §§ 32(c)(2)(b)(i) (earned income tax credit), 402(e)(4)(g)(5) (employee benefit plan distributions), 408(g)(IRA's), 219(f)(2) (deferred compensation deduction limits), 220(b)(4) (Archer MSAs), 223(d)(4)(D) (health savings accounts), 448(d)(4)(A) (limitation on cash method of accounting), 457(d)(7) (certain deferred compensation plans), 530(f) (Coverdell Education Savings Accounts), 932(d) (coordination of US and USVI income taxes), 1402(a) (self-employment tax), and 6015(a) (innocent spouse). *See also Bunney v. Commissioner*, 114 T.C. 259 (2000) (allocating income from IRA distributions without regard to community property law).

[38] *See* IRC § 66(c). Joint filers may obtain similar relief under the "innocent spouse" rules.

- Does not include in gross income for the year an item allocable to the other spouse,
- Establishes that he or she did not know of, and had no reason to know of, such item of community income, and
- Shows that it is "inequitable" to include the item of community income in such individual's gross income (as discussed below).[39] One of the factors for determining inequity is whether the requesting spouse directly or indirectly benefited from the income.[40]

Thus, traditional relief is not available if the requesting spouse knows or has reason to know about a spouse's income, even if he or she did not receive or benefit from any of it. Nor is traditional relief generally available if the nonrequesting spouse uses any of the income to benefit the requesting spouse (*e.g.*, by paying for joint expenses), even if the requesting spouse does not know about the income.[41]

EQUITABLE RELIEF. Equitable relief may be available, in the absence of fraud or certain intra-spousal asset transfers, to relieve one spouse from liability for unpaid tax or deficiency due to the operation of community property laws if the IRS determines it is "inequitable" to hold the individual liable for the tax.[42] The equitable relief test generally focuses on the requesting spouse's:

- Knowledge (or reason to know),
- Economic hardship in the absence of relief,
- Significant benefit from the income,
- Relationship with his or her spouse (*e.g.*, separation, divorce, abuse, etc.),
- Legal rights and obligations pursuant to any divorce decree or agreement,
- Mental and physical health at the time of signing the return, and
- Tax compliance in subsequent years.[43]

Notably, the requesting spouse's knowledge or reason to know about the nonrequesting spouse's income or underpayment is relevant to determining whether to grant equitable relief.

LIMITED PERIOD FOR REQUESTING RELIEF. Taxpayers must request community property relief during potentially short periods, which vary depending on the type of request

[39] *See* IRC § 66(c). Joint filers may obtain similar relief under the "innocent spouse" rules.

[40] *See* Treas. Reg. § 1.66-4(a)(3).

[41] The "benefit" test under IRC § 66 differs from the "significant benefit" test under IRC § 6015, discussed below.

[42] *See* Treas. Reg. § 1.66-4(a)(3); Treas. Reg. § 1.66-4(b).

[43] *See* Rev. Proc. 2003-61, 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1 C.B. 447.

and whether it relates to an underpayment or deficiency.[44] For example, the period for requesting equitable relief with respect to a deficiency year is: after the date the requesting spouse receives notice of an audit or a letter from the IRS indicating that there may be an outstanding liability with regard to the year, and within two years of the first collection activity against the taxpayer with respect to the liability.[45]

SPOUSAL NOTIFICATION. The IRS is required to contact the nonrequesting spouse when the requesting spouse files a claim for relief.[46] The IRS needs to contact the nonrequesting spouse to obtain information relevant to its determination and because relief granted to the requesting spouse will sometimes result in additional tax liability for the nonrequesting spouse.[47] Although this requirement is reasonable, it may inhibit some taxpayers from seeking relief, especially those subject to or recovering from spousal abuse.

Joint and Several Liability

General Rule

Each joint filer is jointly and severally liable for all tax, penalties, and interest due with respect to the joint return, regardless of whether they are domiciled in a community property or common law state.[48] Married taxpayers can avoid such joint and several liability by filing separately, but by filing separately they pay higher tax rates and lose various tax benefits.[49] As one IRS publication helpfully explains, by filing separately:

1. Your tax rates will increase at income levels that are lower than those for a joint return filer.
2. Your exemption amount for figuring the alternative minimum tax will be half of that allowed a joint return filer.
3. You cannot take the credit for child and dependent care expenses in most cases.
4. You cannot take the earned income credit.
5. You cannot take the exclusion or credit for adoption expenses in most instances.
6. You cannot take the credit for higher education expenses (Hope and lifetime learning credits), the deduction for student loan interest, or the deduction for tuition and fees.

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44 *See* Treas. Reg. § 1.66-4(j)(2); Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.01(3) and § 5.

45 *See* Treas. Reg. § 1.66-4(j)(2)(ii); Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.01(3) and § 5.

46 Treas. Reg. § 1.66-4(k).

47 *See* Treas. Reg. § 1.66-4(d), (k).

48 IRC § 6013(d)(3).

49 *See, e.g.*, IRC §§ 21(e)(2) (child and dependent care credit); 22(e)(1) (credit for the elderly or disabled); 23(f)(1) (adoption expense credit); 25A(g)(6) (HOPE and Lifetime Learning credit); 32(d) (earned income credit); 63(c)(6)(A) (separate filer not eligible for standard deduction when spouse itemizes); 86(c)(1)(C)(i) (exclusion for certain social security and railroad retirement benefits), 135(d)(3) (interest exclusion on savings bonds for higher education); 137(e) (adoption assistance exclusion); 221(e)(2) (student loan interest deduction); 408A(c)(3)(B)(ii) (rollover IRA to Roth IRA).

7. You cannot exclude the interest from qualified savings bonds that you used for higher education expenses.
8. If you lived with your spouse at any time during the tax year:
   a. You cannot claim the credit for the elderly or the disabled,
   b. You will have to include in income up to 85% of any social security or equivalent railroad retirement benefits you received, and
   c. You cannot roll over amounts from a traditional IRA into a Roth IRA.
9. Your income limits that reduce the child tax credit, retirement savings contributions credit, itemized deductions, and amount you can claim for exemptions will be half of the limits allowed a joint return filer.
10. Your capital loss deduction limit is $1,500 (instead of $3,000 on a joint return).
11. Your basic standard deduction, if allowable, is half of that allowed a joint return filer.[50]

THE INCOME SPLITTING BENEFIT OF JOINT FILING. Under our progressive tax rate structure, a higher tax is levied upon a set amount of income if it is earned by one taxpayer than if it is earned by two (one-half each). In 1930, the Supreme Court created a tax loophole when it determined that state community property law automatically "splits" a married taxpayer's income for federal income tax purposes, but common law does not.[51] Between 1930 and 1948, married taxpayers domiciled in community property jurisdictions paid less tax than similarly situated taxpayers in common law states if they filed separate returns. In response, Michigan, Nebraska, Oklahoma, Oregon, Pennsylvania, and Hawaii adopted community property laws, so their citizens could enjoy the income splitting benefit.[52] In 1948, Congress extended this benefit to all married couples filing joint returns by reducing tax rates for joint filers.[53] However, geographic disparity still exists for married taxpayers who file separately because those in community property jurisdictions enjoy the income splitting benefit, but those in common law jurisdictions do not. Under the facts of Example 4, above, H's and W's combined liability is significantly higher if they file separately than if they file jointly, especially if they are domiciled in a common law state, as shown in the following table.

[50] IRS Pub. 504, *Divorced or Separated Individuals* 4-5 (2005).

[51] *Poe v. Seaborn*, 282 U.S. 101 (1930).

[52] *See* Joseph D. Seckelman, 3 Mertens Law of Fed. Income Tax'n § 19:02 (West 2004).

[53] *See* Pub. L. No. 471, 80th Cong., 2nd Sess. (Apr. 2, 1948). Interestingly, after passage of the Revenue Act of 1948 all of the newly converted community property states repealed their community property laws, presumably because their citizens could obtain the income splitting benefit by filing jointly. See Joseph D. Seckelman, *supra*.

TABLE 2.4.3, H AND W'S FEDERAL TAX SAVINGS FROM JOINT FILING BY STATE

	Illinois (common law)	California (community)	Wisconsin (community)
Combined Separate Liabilities	$28,687	$27,813	$24,914
Joint Liability	$24,900	$24,900	$24,900
Tax Savings from Joint Filing	**$3,787**	**$2,913**	**$14**

H and W would save $3,787 by filing jointly if they lived in Illinois, a common law state, but only $14 if they lived in Wisconsin, a community property law state. This savings reflects the income-splitting benefit available to joint filers.

Example 5: Joint and Several Liability for Understatements. Assume the same facts described in Example 4, above, except that H and W file a joint return and W omits her $10,000 bonus. The joint liability shown on the return would be $22,230 regardless of which state law applies. Although H earned only $24,000 he would be liable for tax of $24,900 on joint income of $142,000, including the $2,670 understatement ($24,900 tax required to be shown on the joint return - $22,230 tax actually shown on the joint return), even though he received no benefit from W's income and did not live with W for most of the year. H may only avoid liability for the entire $24,900 plus interest and penalties if innocent spouse relief is granted.

Joint and Several Liability Relief – Innocent Spouse Rules

If a taxpayer files a joint return, he or she may obtain relief from joint and several liability for understatements of tax by filing a timely claim under IRC § 6015 for "traditional" innocent spouse relief, a "separate liability election," or "equitable" relief.[54] "Equitable relief" may also apply to underpayments.[55] Any determination under IRC § 6015 is made without regard to community property law.[56] Thus, joint filers in community property states may obtain relief from both joint and several liability and community property rules under IRC § 6015.

TRADITIONAL RELIEF. To obtain traditional relief the taxpayer must demonstrate:

- An understatement of tax is attributable to an erroneous item of the nonrequesting spouse (determined without regard to community property law),
- The requesting spouse did not know or have reason to know of the understatement; and
- It would be "inequitable" to hold the requesting spouse liable (discussed above).[57]

[54] IRC § 6015(b) (traditional relief), 6015(c) (separate liability election), 6015(f) (equitable relief).

[55] IRC § 6015(f).

[56] IRC § 6015(a).

[57] IRC § 6015(b); Treas. Reg. § 1.6015-2(a).

Thus, as with traditional community property relief, traditional innocent spouse relief is not available if the taxpayer knew or had a reason to know about the understatement.

SEPARATE LIABILITY ELECTION FOR TAXPAYERS SEPARATED FOR 12 MONTHS. A taxpayer may make a separate liability election if:

- The taxpayer is divorced, legally separated, widowed, or was not a member of the same household as his or her spouse for the 12-month period ending on the date of the election;[58]
- The IRS does not demonstrate that he or she had actual knowledge of the item giving rise to the understatement;[59] and
- No assets were transferred between the spouses as part of a fraudulent scheme.[60]

A separate liability election limits a taxpayer's liability for deficiencies on the joint return to the proportion of the deficiency allocable to his or her items (without regard to community property laws).[61] The portion of any deficiency allocated to the electing spouse, however, is increased by the value of any assets transferred to the electing spouse from the nonelecting spouse with the principal purpose of tax avoidance.[62]

EQUITABLE RELIEF. If a taxpayer is not eligible for traditional innocent spouse relief or a separate liability election, and it would be "inequitable" to hold the taxpayer liable, the taxpayer may qualify for equitable relief.[63] The equitable relief test is similar to the equitable relief test applied in the context of community property relief.[64] A taxpayer may obtain equitable relief for both deficiencies and underpayments of tax. The IRS generally considers the same facts and circumstances under this test as the other equitable relief tests, except that it will ordinarily grant relief for underpayments if the requesting spouse:

- Is no longer married to, is legally separated from, or was not a member of the same household as the nonrequesting spouse for the previous 12 months;
- Will suffer an economic hardship if the IRS does not grant relief; and
- Had no knowledge or reason to know that the nonrequesting spouse would not pay the tax liability.[65]

58 IRC § 6015(c)(3)(A)(i); Treas. Reg. § 1.6015-3(a).

59 IRC § 6015(c)(3)(C).

60 IRC § 6015(c)(3)(A)(ii).

61 IRC §§ 6015(c)(1), (d); 6015(a). Items otherwise allocable to the nonelecting spouse are allocated to the electing spouse to the extent he or she received a tax benefit on the joint return from such items. IRC § 6015(d)(3)(B).

62 IRC § 6015(c)(4).

63 IRC § 6015(f); Treas. Reg. § 1.6015-4.

64 *See* Rev. Proc. 2003-61, 2003-2 C.B. 296, *superseding* Rev. Proc. 2000-15, 2000-1 C.B. 447.

65 *See id.* at § 4.02.

Notably, the requesting spouse's knowledge or reason to know of the underpayment or deficiency is relevant to determining whether to grant equitable relief.

LIMITED PERIOD FOR REQUESTING RELIEF. The IRS will not consider a taxpayer's request for relief from joint and several liability filed before the date the requesting spouse receives notice of an audit or a letter from the IRS indicating that there may be an outstanding liability with regard to the year.[66] In addition, the IRS will not consider any such request filed after the two-year period beginning on the date of any collection activity.[67]

SPOUSAL NOTICE. As with community property relief requests, the IRS is required to contact the nonrequesting spouse after the requesting spouse files a claim for relief in order to give the nonrequesting spouse an opportunity to submit information to the IRS.[68] In addition, the nonrequesting spouse may appeal the IRS's preliminary decision to grant relief before the decision becomes final.[69]

Collection

Collection of Property Controlled by a Nonliable Spouse

COMMON LAW STATES. In common law states, the IRS may collect a taxpayer's separate property as well as one-half of any property held jointly or as joint tenancy by the entireties.[70] The IRS may not garnish a taxpayer's wages to collect his or her spouse's separate liability.[71]

COMMUNITY PROPERTY STATES. In community property states, the IRS may generally collect one spouse's separate liability out of his or her separate property as well as any community property held by, and community income earned by, the nonliable spouse.[72] Thus, in community property states the IRS may garnish a person's wages to collect a liability that the IRS has determined is solely the other spouse's responsibility. Depending on the state, the IRS's right to collect against the nonliable spouse may depend upon whether the liability was incurred before, during, or after the marriage, or on the existence of certain marital agreements.[73]

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66 *See id*; Treas. Reg. § 1.6015-5(b)(1), (5).

67 IRC §§ 6015(b)(1)(E); 6015(c)(3)(B); Rev. Proc. 2003-61, 2003-2 C.B. 296, § 4.01(3) and § 5; IRM § 25.15.5.11 (May 1, 2005).

68 *See, e.g.*, IRC § 6015(h)(2); Treas. Reg. § 1.6015-6(a)(1); Publication 971, *Innocent Spouse Relief (And Separation of Liability and Equitable Relief)* (Mar. 2004).

69 *See id*; Rev. Proc. 2003-19, 2003-1 C.B. 371.

70 *See, e.g.*, *United States v. Craft*, 535 U.S. 274 (2002); Notice 2003-60, 2003-2 C.B. 643.

71 *See id.*

72 *See, e.g.*, *Medaris v. U.S.*, 884 F.2d 832 (5th Cir. 1989). In addition, the IRS may collect a liable spouse's tax out of the nonliable spouse's community property that is controlled by the liable spouse. *Id.*

73 *See* IRM § 25.18.4 (Feb. 15, 2005).

IRS Not Subject to State Law Exemptions Protecting Nonliable Spouses

State law exemptions sometimes prevent creditors, other than the federal government, from collecting income earned or controlled by a nonliable spouse to satisfy the liable spouse's debts. Under Texas law, for example, any community property subject to a spouse's sole "management, control, and disposition" (*e.g.*, wages) is generally not subject to collection by his or her spouse's creditors.[74] Unlike other creditors, however, the IRS is not subject to any such state law exemptions and may collect at least one-half, and sometimes all, of any community property or community income to satisfy one spouse's separate liability.[75]

Transferee Liability Addresses Abusive Transfers to a Spouse

If the IRS cannot collect separate liabilities from the liable spouse, transferee liability will often permit the IRS to collect the tax liability from the nonliable spouse or any other person to whom the liable spouse transferred property.[76] In general, transferee liability may arise from property transfers for less than reasonably equivalent value if the debtor:

- Is insolvent or becomes insolvent as a result of the transfer; or
- Made the transfer with actual intent to hinder, delay, or defraud a creditor.[77]

If transferee liability applies, the transferee is secondarily liable for the lesser of: (a) the amount of the liability and (b) the value of the property received from the debtor.[78] Because the transferee is secondarily liable (rather than primarily liable) for the transferor's debt, the government must exhaust efforts to collect from the transferor before attempting to collect from the transferee, unless such efforts would be futile.[79]

REASON FOR CHANGE[80]

Marriage Does Not Extinguish Individual Economic Identity

Taxing each spouse on one-half of the community income and imposing joint and several liability for a spouse's taxes are each logical extensions of the concept that marriage extinguishes an individual's identity, merging husband and wife into a single economic

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[74] *See* TEX. FAMILY CODE ANN. § 3.202 (Vernon 2004) (successor to §5.61(b)).

[75] *See* IRC §§ 6321 (liens); IRC § 6331(a) (levies); 6334(c) (no exemptions from levy other than those specifically identified); *U.S. v. Mitchell*, 403 U.S. 190 (1971). *See also Medaris v. U.S.*, 884 F.2d 832 (5th Cir. 1989).

[76] *See* IRC § 6901.

[77] *See* Subpart D of the Federal Debt Collection Procedures Act of 1990, 28 U.S.C. §§ 3301-3308 (West 2005). State fraudulent conveyance statutes provide the IRS with additional rights to collect from transferees. *See, e.g.*, IRM § 4.10.13.3 (Mar. 30, 2005).

[78] *See id.*

[79] *See id. U.S. v. Russell*, 241 F.2d 879 (1st Cir.1957).

[80] The reasons for change have been comprehensively discussed elsewhere. *See, e.g.*, Richard C.E. Beck, T*he Innocent Spouse Problem: Joint And Several Liability for Income Taxes Should be Repealed*, 43 Vand. L. Rev. 317 (Mar. 1990); 1995 ABA Recommendation; AICPA Comments.

unit.[81] A 1923 ruling justified joint and several liability on the basis that "a single joint return is one return of a taxable unit and not two returns of two units on one sheet of paper."[82] Under this reasoning, it does not matter if one spouse pays tax on the other spouse's income because the law does not recognize individual members of the economic unit.

In reality, husbands and wives are individuals who often have separate assets and incomes that they do not control equally. In 2001, 61 percent of all married women and 77 percent of all married men worked outside the home.[83] One recent survey estimated that 48 percent of married couples have separate checking accounts.[84] About 3.2 million happily married couples do not even live together and another 4.5 million are separated because of marital discord.[85] At current rates, about 48 percent of all American marriages are expected to end in divorce within the next 20 years, in which case they will separate their finances even further.[86] Most importantly, studies confirm that even married taxpayers who live together do not control income equally.[87] Thus, for the tax law to treat all married taxpayers as a single economic unit does not align with their behavior.

Tax Not Imposed In Accordance with "Ability to Pay"

Because married taxpayers do not always share income equally, taxing one spouse on income earned by the other or holding one spouse liable for tax on the other's income violates the fundamental principle that tax should be imposed in accordance with ability to pay.[88] The Ninth Circuit stated in *Cole v. Commissioner*:

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81 For a recent discussion of the evolution of this theory, *see* Bryan T. Camp, *The Unhappy Marriage of Law and Equity in Joint Return Liability*, 108 Tax Notes 1307 (Sept. 12, 2005).

82 I.T. 1575, II-1 C.B. 144 (1923).

83 *See* U.S. Census Bureau, Statistical Abstract of the United States, No. 568. Labor Force Participation Rates by Marital Status, Sex, and Age: 1970 to 2001 (2002), *available at* http://www.census.gov/prod/2003pubs/02statab/labor.pdf.

84 *See* MSN Money, *Marriage and Money: Coordination is Key* (July 25, 2005) *at* http://msnbc.msn.com/id/8418129/ (last visited Dec. 7, 2005) (citing a survey of 1,200 households by the Raddon Financial Group in Oakbrook Terrace, Illinois).

85 U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplement (Feb. 22, 2005), *available at* http://www.census.gov/population/socdemo/foreign/ppl-176/tab05-2.pdf (2004 data, Table 5.2).

86 *See* Andrew J. Cherlin, *American Marriage in the Early Twenty-First Century, The Future of Children*, 36 (Princeton-Brookings, Fall 2005), *available at* http://www.futureofchildren.org/usr_doc/03_FOC_15-2_fall05_Cherlin.pdf.

87 *See, e.g.*, Frances Woolley, *Control over Money in Marriage*, MARRIAGE AND THE ECONOMY, 105-129 (Shoshana A. Grossbard-Schechtman ed., Cambridge University Press 2003) (May 2000) *available at* http://www.carleton.ca/economics/cep/cep00-07.pdf; Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return*, 45 Hastings L.J. 63, 80-92 (1993) (citing several studies).

88 Such a tax also contradicts the fundamental principle that income is taxed to the person who earns and controls it even if another receives or otherwise benefits from the income. *See, e.g., Lucas v. Earl*, 281 U.S. 111, 114-15 (1930); *Helvering v. Horst*, 311 U.S. 112 (1940). *Accord* IRC § 678.

> One of the fundamental principles of taxation is that the incidence of a tax should be in accordance with the ability to pay. In income taxation, this means that the tax should be levied in proportion to income.... If this cardinal principle is followed, justice will be done.[89]

Perhaps for this reason, joint and several liability for married filers is the exception rather than the norm in the international community.[90]

IRS statistics suggest that joint and several liability and community property rules often require low income women who are divorced and caring for children to pay a husband's or ex-husband's tax liability (or pay tax on his income) unless relief is applicable. For example, 65 percent of the taxpayers who request innocent spouse or community property relief make less than $30,000 per year.[91] Ninety percent are women.[92] Thirty-four percent are single filers and another 51 percent file as "head of household," meaning they are unmarried and maintain a home for children or other persons.[93]

Even imposing one-half (rather than all) of the liability on each spouse would not, on average, tax them in accordance with ability to pay. As noted above, studies confirm that spouses often do not control marital assets equally; rather, the spouse with greater earnings exerts more control.[94] On average, women earn only 25 percent of the income reported on a joint return.[95] Thus, the most frequent effect of joint and several liability may be to require low income women who are often raising children by themselves, to insure the IRS against underreporting or underpayment of tax on income earned by a husband or former husband. The community property rules have a similar affect.

Relief Rules Imperfect

Spouses Must Audit Each Other

To avoid being the government's insurer against a spouse's noncompliance, an "innocent spouse" must often show that he or she had no "actual knowledge" or "reason to know" of a spouse's underreporting or underpayment.[96] For example, a wife is expected

[89] *Cole v. Commissioner*, 81 F.2d 485, 487 (9th Cir. 1935), *rev'g*, 29 B.T.A. 602 (1933).

[90] *See, e.g.*, 1995 ABA Recommendation; Richard C.E. Beck, *The Innocent Spouse Problem: Joint And Several Liability for Income Taxes Should be Repealed*, 43 Vand. L. Rev. 317, 382-389 (Mar. 1990).

[91] W&I Research, Strategic Forecasting & Analysis, Innocent Spouse Data Summary (Oct. 3, 2005) (statistics based on 2001 data).

[92] *Id.*

[93] *Id.*

[94] *See, e.g.*, Frances Woolley, *supra, note 87* (concluding that the spouse with a higher income generally has more control over marital assets).

[95] W&I Research, Strategic Forecasting & Analysis, Innocent Spouse Data Summary (Oct. 3, 2005) (statistics based on 2001 data).

[96] One of the most common reasons for innocent spouse and community property claims to be denied is because of the taxpayer's knowledge or reason to know. Innocent Spouse Tracking System (Jan. 30, 2005).

to show that she exercised due diligence to detect and rectify a husband's noncompliance. When a husband prepares a joint return reporting his income and tells his wife to sign it, (absent abuse) she is expected to review the return and cause him to correct any inaccuracies that she has "actual knowledge" or "reason to know" about.[97] If she entrusts the family tax affairs to her husband, relief may not be available. To be prudent, each spouse should actively participate in preparing the joint return. Indeed, since ignorance of the law is not considered in determining a taxpayer's reason to know, each spouse may be well advised to consult with a tax advisor.[98] Such duplicated efforts frustrate one of the primary non-tax benefits of joint filing, *i.e.*, the benefit of delegating to one spouse the responsibility for preparing the family tax return and communicating with a professional tax preparer, if necessary.

Spouses Must Investigate Each Other Even if Filing Separately

The community property relief rules have a similar requirement that a spouse must not have any reason to know about a spouse's income.[99] As a result, even separate filing will not discharge married taxpayers from their duty to investigate a spouse on the government's behalf, at least if they are domiciled in a community property state.

Innocent Spouse Processing Difficulties

In contrast to our normal self-assessment tax system in which taxpayers determine their liability, the relief rules require the IRS to make complex and time consuming case-by-case determinations, provided taxpayers can figure out how to apply for relief within the limited periods for requesting it.[100] Once they apply for relief, which is granted on only about 30 percent of all claims, taxpayers have to wait months or years to obtain it.[101] In FY 2005, the IRS took 192 days to process innocent spouse claims that the examination function ultimately allowed in full.[102] Processing time jumps to 807 days, or more than two years, for claims elevated to the Appeals function. Taxpayers may have to wait even longer if litigation is required. Interest and penalties continue to accrue during these periods. Further, under current law some taxpayers may be unable to obtain any meaningful review of IRS decisions by a court.[103]

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97 The "no actual knowledge" requirement does not apply in cases where the requesting spouse establishes that he or she was a victim of domestic abuse and that the abuse resulted in the requesting spouse's failure to challenge the treatment of an item on the joint return. *See* Treas. Reg. § 1.6015-3(c)(2)(v). However, the spousal notification requirements may inhibit such persons from seeking relief.

98 *See e.g.*, Treas. Reg. § 1.6015-3(c)(2)(ii).

99 *See* IRC § 66(c)(3).

100 *See* Most Serious Problem: *Innocent Spouse Claims, supra* (discussing challenges faced by the Innocent Spouse Program).

101 Policy Analyst, W&I, Compliance Reporting Compliance and Policy, Response to Information Request (Oct. 14, 2005).

102 *See* Most Serious Problem: *Innocent Spouse Claims, supra.*

103 *See, e.g.*, Bryan T. Camp, *The Unhappy Marriage of Law and Equity in Joint Return Liability*, 108 Tax Notes 1307 (Sept. 12, 2005) (describing how jurisdictional rules may deny court review to deserving taxpayers and result in the application of different standards of review depending upon the procedural posture of the case).

Joint Filing – A Trap for the Unwary and those Seeking Marital Harmony

Many married taxpayers are probably unaware that they may avoid joint and several liability by filing separately. Form 1040, *U.S. Individual Income Tax Return*, does not warn taxpayers that filing a joint return will result in joint liability.[104] Although the Form 1040 instruction booklet discloses that joint filing may subject a taxpayer to joint and several liability, it offers a "tip," that taxpayers should "chose the one [filing status] that will give you the lowest tax."[105] Of course, taxpayers who have delegated responsibility for family tax preparation to a spouse are unlikely to read the instruction booklet. Taxpayers who are aware of the consequences of joint filing are probably most aware that federal income tax rates (the "income splitting" benefit) and various tax benefits often provide an immediate incentive for married taxpayers to file jointly.

Even if a taxpayer knows that joint filing may theoretically subject him or her to liability for a spouse's understatement or underpayment, it may be just as difficult to believe that a trusted spouse might understate or underpay his or her taxes as it is to believe that the marriage might end in divorce. Although researchers expect almost half of all marriages to result in divorce, only 1.5 to 10 percent of all married taxpayers enter prenuptial agreements.[106] Studies attribute the relatively low number of such agreements to optimism, bias, and a fear of signaling distrust to a fiancé.[107] Similar concerns may deter married taxpayers from filing separately. Even if one spouse does not necessarily trust the other, he or she may be faced with a choice of (a) signing the joint return without question, (b) questioning a spouse's tax reporting, or (c) filing separately, which may cost the family significant tax benefits. The only choice that does not present the possibility of marital conflict is to sign the joint return without question. Perhaps for this reasons, taxpayers rarely take the precaution of filing separately. Ninety seven percent of all married filers, over 100 million taxpayers, submitted joint returns for tax year 2003, subjecting themselves to joint and several liability for a spouse's tax.[108]

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104 *See* Form 1040, *U.S. Individual Income Tax Return* (2005).

105 Instructions for Form 1040, *U.S. Individual Income Tax Return* 16-17 (2005).

106 *See, e.g.*, Heather Mahar, *Why Are There So Few Prenuptial Agreements?*, Harvard John M. Olin Discussion Paper No 436 (Sept. 2003), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/436.pdf.

107 *See, e.g.*, *id.*

108 Of the 104 million married filers, 101 million filed jointly. TAS Research, Tax Year 2003 IRTF Data (May 3, 2005).

Little Justification for Joint and Several Liability

Price of Joint Filing

One rationale sometimes given for joint and several liability is that it is the price married taxpayers must pay for joint filing.[109] Historically, however, joint filing did not always trigger joint liability. The privilege of joint filing was granted by the Revenue Act of 1918, but joint filers were not subject to joint and several liability until 1938.[110] More importantly, the amount of any joint liability bears no relation to the benefits of joint filing. Moreover, if joint liability is the price of joint filing, the price is imposed on the wrong spouse. The spouse who has the highest income derives the greatest income-splitting benefit from joint filing, but the price of joint filing – liability for a spouse's taxes – is often imposed on the spouse with the lowest income, as illustrated above. Thus, the benefits of joint filing do not justify joint and several liability.

Administrative Reasons

In 1938, when Congress explicitly imposed joint and several liability, legislative history cited "administrative" reasons.[111] Eliminating joint and several liability would affect how both taxpayers and IRS administer their respective responsibilities.

ADMINISTRATIVE ISSUES FOR THE IRS. In 1998, when the Treasury Department studied the option of eliminating joint and several liability and requiring married taxpayers to file separate returns, it noted a number of administrative challenges the IRS would face, including the following:

- IRS computer systems would need an upgrade to handle separate liabilities;
- The IRS's data entry costs would increase;
- The IRS would need to revise its document matching and audit selection criteria and techniques; and
- The IRS might have difficulty collecting separate liabilities out of assets owned as joint tenancy by the entireties.[112]

These administrative challenges have significantly declined since 1998, as follows:

- **Computer Issues.** In 2005, the IRS began to use a computer system called the Customer Account Data Engine (CADE), which will gradually replace its old "master file" and certain "non-master file" systems over the next few years.[113] We

109 The IRS made such an argument in the *Cole* case. *See Cole v. Commissioner*, 81 F.2d 485, 487 (9th Cir. 1935), *rev'g*, 29 B.T.A. 602 (1933) (joint filers **not** jointly and severally liable for tax).

110 *See id*; Revenue Act of 1938, Pub. L. No. 75-554, Ch. 289, § 51(b), 52 Stat. 447, 476.

111 H.R. Rep. No. 1860, 75th Cong., 3d Sess. (1938), 1939-1 C.B. (Part 2) 728, 749.

112 *See* Department of the Treasury, Report to the Congress on Joint Liability and Innocent Spouse Issues 27-43 (Feb. 1998).

113 *See* David Perera, IRS 5.0 - *After numerous failed modernization efforts, the IRS now believes it has a model that works*, Federal Computer Week (July 18, 2005).

understand that CADE could be programmed to handle separate liability processing. Thus, computer system limitations would be less challenging today than they were in 1998.

- **Data Entry.** The IRS received only 19 percent (25 million out of 123 million) of all tax individual income tax returns electronically in FY 1998, but that figure increased to 52 percent (68 million out of 131 million) in FY 2004, and the IRS goal is to increase the number of returns received electronically to 80 percent by 2007.[114] Because returns received electronically do not require significant data entry, a split column return would not entail as much additional data entry today as it would have in 1998.
- **Collection Issues.** In 2002 the Supreme Court held that the IRS could collect separate tax liabilities out of property held as joint tenancy by the entireties.[115] Thus, the IRS would not have as much difficulty collecting separate liabilities out of assets held as joint tenancy by the entireties if joint liability were eliminated as it might have had prior to 2002.

The IRS's administrative challenges could also be partially offset by the reduction in, or elimination, of innocent spouse relief, community property relief, injured spouse relief, and numerous Internal Revenue Code (IRC) provisions that override community property rules in an *ad hoc* fashion, as noted above.

ADMINISTRATIVE ISSUES FOR TAXPAYERS. If married taxpayers filing jointly were not subject to joint and several liability, they would need to provide the IRS with enough information to divide tax liabilities and tax payments. Although providing such information would involve some additional effort, in most cases the additional effort would be minimal for the following reasons.

- **Information Reporting and Tax Forms Make it Easier.** In most instances, married taxpayers could readily allocate items solely based on information reported to them by employers, the government, and financial institutions. At least 84 percent of all income reported on tax returns in TY 2002 was subject to information reporting, including income from: wages (73 percent), pensions (6 percent), interest (3 percent), and social security (2 percent).[116] Similarly, about 99 percent of all voluntary payments in TY 2002 were allocable to withholding (67 percent), estimated tax payments (21 percent), payments included with the return (7 percent), or payments included with an extension request (4 percent).[117] Like wages, withholding is subject to information reporting, which should help married taxpayers determine how

114 IRS Pub 55B, Data Book (Mar. 1998) (Tables 3 and 4); IRS Pub 55B, Data Book (Mar. 2005) (Tables 3 and 4); IRS Restructuring and Reform Act of 1998, Pub. L. 105-206 § 2001 (1998) (IRC § 6011 (note)).

115 *See United States v. Craft,* 535 U.S. 274 (2002); Notice 2003-60, 2003-2 C.B. 643.

116 TAS Research, Tax Year 2002 Compliance Research Information System Model From 1040 PY 2003 V1 (Dec. 19, 2005).

117 *Id.*

much each paid the IRS. The IRS could easily revise the estimated tax payment and extension forms to allow married taxpayers to allocate estimated tax payments and payments made with extensions. Payments made with the return would be allocated on the face of the return. Thus, existing information reporting combined with a few tax form changes could minimize the effort required for most married taxpayers to allocate their items of income, deduction, and payment or credit on their return.[118]

- **Information Already Provided on State Tax Returns.** Many married taxpayers already allocate income reported to state tax authorities when they file their state income tax returns. For example, married taxpayers filing combined returns in Arkansas, Delaware, Iowa, Kentucky, Mississippi, and Montana must report each spouse's income separately.[119] It would be easy for taxpayers who already report income separately for state tax authorities to provide the same information to the IRS.
- **Information Already Provided on Injured Spouse Forms.** Some taxpayers already provide the IRS with information sufficient to allocate both tax liability and payments when one spouse (called an "injured spouse") requests his or her portion of a joint overpayment that the IRS would otherwise offset against a single spouse's debt, such as child support, state or federal income taxes, or student loans.[120] However, some taxpayers provide this allocation information either with the joint return or months or years after they initially prepare it. By collecting such information on all joint returns, the IRS would save many taxpayers the trouble of providing the same information in connection with an injured spouse request when records may no longer exist.
- **Spouses Could Stop Auditing Each Other.** Married taxpayers who do not allocate items on a state return or file an "injured spouse" claim might have to spend additional time to allocate items on their federal return. However, the burden of allocating items on a return would be offset, at least in part, by the fact that married taxpayers would no longer be expected to question items reported by a spouse or whether a spouse was really going to pay the tax. Moreover, as discussed above, this allocation burden should be minimal for income subject to third-party information reporting.

[118] However, separate filers are sometimes required to trace payments to allocate expenses under current law. *See, e.g.*, IRS Pub. 504, *Divorced or Separated Individuals* 5 (2005); Richard C.E. Beck, *supra*, 393-400 (discussing current law) and Martha W. Jordan, *The Innocent Spouse Problem: Defining A Proportionate Solution*, 24 Ohio N.U. L. Rev. 517, 527-541 (1998) (same). For example, deductions for interest and taxes can only be taken by the spouse who is liable, even if they are paid out of separate funds of another. *See id.* If both spouses are jointly liable for an expense then the spouse who paid the expense may be entitled to the deduction. *See id.* If joint or community funds are used to pay a joint expense, each spouse may be entitled to one-half of the deduction. *See id.* Congress should consider simplifying these allocation rules.

[119] Married taxpayers in Virginia filing a joint state income tax return must report each spouse's income separately to obtain an adjustment to reduce the state marriage penalty. *See* Virginia 760 Resident Individual Income Tax Booklet 12-13 (2004) available at http://www.tax.virginia.gov/Web_PDFs/indForms/currentyear/760instweb.pdf (Line 16, Spouse Tax Adjustment (STA)).

[120] *See, e.g.*, Form 8379, *Injured Spouse Claim and Allocation* (Dec. 2002).

Little Potential for Abuse

Separate liability would not significantly increase the potential for abuse. Married taxpayers willing to divert assets or income from one spouse to the other to intentionally avoid paying tax liabilities can already avoid joint and several liability under current law by filing separately. However, such a strategy is generally undesirable, primarily for two reasons. First, transferee liability is likely to follow any assets transferred with intent to defraud creditors, even if the transferor is not rendered insolvent by the transfer. Second, such a strategy actually requires one spouse to transfer assets or income to the other. Since almost half of all marriages are expected to end in divorce, it is risky to try to avoid tax liabilities by shifting a significant amount of assets or income to a spouse.

Limits on Collection

Existing collection rules allow the IRS to collect one spouse's separate liability from the other spouse's income and assets, even in cases where other creditors in the same situation cannot.[121] IRS collection actions against a nonliable spouse may present the very same inequity that the innocent spouse relief rules are intended to rectify. Such collections undermine the purpose of the injured spouse rules. Further, such broad collection powers are unnecessary. Existing transferee liability laws allow the IRS to collect one spouse's liability out of assets transferred to the other spouse in abusive situations.[122]

To be sure, any restraints on the IRS's collection powers should not unduly impair its ability to collect delinquent taxes, nor should they primarily benefit other creditors instead of the nonliable or innocent spouse. By the same token, it makes no sense for the IRS to grant innocent spouse relief and then collect the very same liability from the innocent spouse. In balancing these concerns, we considered the following alternatives:

- **Prohibiting the IRS from levying on a nonliable spouse's wage, pension, disability, and similar payments.** An exception could apply to the extent that such payments are used for the benefit of the liable spouse. This approach would put taxpayers in community property jurisdictions on a more equal footing with those in common law jurisdictions, where the IRS generally cannot reach such payments. In some cases, this approach might benefit other creditors, but in other cases these creditors would be prohibited from collecting such assets under state law exemptions.
- **Subjecting the IRS to the same collection exemptions that apply to other creditors under state law.** Such limitations would not primarily benefit other creditors because other creditors are subject to collection exemptions provided under state law. For example, as noted above, in Texas other creditors cannot collect one

121 *See, e.g., Medaris v. U.S.*, 884 F.2d 832 (5th Cir. 1989). The IRS's collection powers are also superior in other ways. For example, unlike other creditors, the IRS may use its administrative levy and seizure powers to enforce a tax lien without judicial assistance. *See, e.g.*, IRC § 6331.

122 If Congress is concerned about abuse, it could supplement existing transferee liability as it has in connection with separate liability elections. *See* IRC § 6015(c)(4) (reducing relief to the extent of any "disqualified asset" transfers with the "principal purpose" of tax avoidance).

spouse's liability out of assets under the other spouse's management and control. However, applying state exceptions to the IRS would perpetuate differences between the states.

- **Requiring the IRS to exhaust reasonable efforts to collect assets under the liable spouse's control before collecting against assets under the nonliable spouse's control.** Although this requirement might slow down collection of assets held by a nonliable spouse, it would not foreclose the IRS's ability to reach them. In some cases this approach might benefit other creditors, but in many cases other creditors would be prohibited from collecting such assets under state law exemptions. Moreover, a similar requirement often applies when the IRS seeks to collect under transferee liability provisions.

EXPLANATION OF RECOMMENDATIONS

Repeal Joint and Several Liability

Split Column Return

Married taxpayers would file on a split-column tax return to contemporaneously identify separate income, deductions, credits, and payments. The return would be similar to the combined return adopted by a number of states.[123]

When to Sever the Joint Liability

For ease of administration, this proposal would (1) separate the joint liability when the IRS first asserts an underpayment or deficiency against a joint filer, and (2) disallow separate refunds of amounts, voluntarily paid before the IRS asserts an underpayment or deficiency, that would otherwise result from severing the joint liability. These modifications would relieve the IRS from having to collect underpayments from one spouse while simultaneously refunding voluntary overpayments to the other with respect to a single tax year.

Example 6: When to Sever the Joint Liability. Assume the facts of Example 5: H and W file a joint return that shows net income of $132,000, $108,000 allocated to W and $24,000 to H. The total tax liability on the return is $22,230. If the tax liability were separated, H would be liable for $1,769 and W would be liable for $20,461. H and W each voluntarily pay $11,115. Because the IRS has not yet asserted a deficiency or underpayment, the liability remains joint and several. As a result, the IRS does not need to issue a $9,346 refund to H and assess a $9,346 underpayment against W. When the IRS asserts a deficiency attributable to W's $10,000 underreported income, the joint liability would automatically separate so that W would be separately liable for the entire deficiency. Because H voluntarily overpaid his share of liability before the IRS asserted an underpayment or deficiency, he would not be entitled to a refund.

[123] *See* National Taxpayer Advocate 2001 Annual Report to Congress 144-145 (illustrating a federal split-column return).

How to Sever the Joint Liability

SEPARATE LIABILITY FORMULA ALREADY EXISTS UNDER CURRENT LAW. Joint liabilities could be allocated under current law. Under current law, the aggregate joint liability is allocated to each spouse in proportion to his or her hypothetical liability computed as if he or she filed separately.[124] Thus, any legislative repeal of joint and several liability would not need to change existing rules for allocating each spouse's share of the joint liability.

However, for ease of administration under our proposal in the case of assessments for deficiency, joint liability would be separated on an item-by-item basis. The item-by-item method would be similar to how deficiencies are allocated when taxpayers make a separate liability election under IRC § 6015.[125] There would be no need to recompute each spouse's hypothetical liabilities as if they filed separately to determine each spouse's share of a deficiency, as there would be under current law. When the IRS has enough information to assert a deficiency, it should have little difficulty determining whose income was omitted or whose deduction was overstated.

Example 7: How to Allocate Joint Liability. Assume the same facts as Example 6. The joint return shows a $22,230 liability but contains a $2,670 tax deficiency attributable to W's $10,000 bonus. If the return reflected W's bonus, the liability would be $24,900 ($22,230 tax on the income shown + $2,670 tax on the unreported bonus). If H and W filed using the married filing separately (MFS) filing status, H would have been liable for tax of $2,009 and W would have been liable for tax of $26,678 ($23,238 tax on income shown + $3,440 tax on the unreported bonus).

Under current law, if joint and several liability were simply repealed, upon filing the joint return, H would be liable for $1,769 and W would be liable for $20,461, representing each spouse's share of the $22,230 liability reported on the return.[126] When the IRS assesses the tax deficiency, H would be liable for $1,744 and W would be liable for $23,156, representing their respective shares of the $24,900 liability after the assessment.[127] Because each spouse's share of the liability is based on what his or her liability would have been if he or she filed separately, each spouse's MFS liability has to be recomputed each time an item is adjusted on the return. Our proposal would not require such recomputation. Understatements would be allocated on an item-by-item basis.

124 The separate liability formula for making such an allocation is: (one spouse's separate tax / sum of both spouse's separate tax) * joint liability. *See, e.g.*, Rev. Rul. 80-7, 1980-1 C.B. 296.

125 *See* IRC §§ 6015(c) and (d).

126 H's $1,769 liability is computed as follows: $22,230 joint liability * $2,009 H's MFS liability / ($23,238 + $2,009) the sum of H and W's MFS liability). W's $20,461 liability is computed as follows: $22,230 joint liability * $23,238 W's MFS liability / ($23,238 + $2,009) the sum of H and W's MFS liability).

127 H's $1,744 liability is computed as follows: $24,900 total joint liability * $2,009 H's MFS liability / ($2,009 + $26,678) the sum of H and W's MFS liability). W's $23,156 liability is computed as follows: $24,900 total joint liability * $26,678 W's MFS liability / ($2,009 + $26,678) the sum of H and W's MFS liability).

Under our proposal, H would be liable for $1,769, representing his portion of the liability reported on the joint return. W would be liable for $23,131, representing her share of the liability reported on the joint return ($20,461), plus the entire understatement of tax ($2,670) attributable to her $10,000 bonus.

Simplification and Burden Reduction

Eliminating joint and several liability and requiring joint filers to use a split-column return would facilitate significant simplification and burden reduction in other areas. For example, separating individual tax liabilities would reduce complexity and the administrative burdens imposed by current relief rules. Spouses would no longer need to investigate each other to ensure tax compliance, and the current innocent spouse rules could be significantly simplified or eliminated.[128] In addition, since the IRS would have enough information to allocate any refund at the outset, one spouse would not need to request injured spouse relief to keep the IRS from offsetting his or her refund against a spouse's separate liabilities. Rather the IRS could automatically ensure that one spouse's share of a joint overpayment is not offset against the other spouse's separate liability.

Repeal Seaborn – Allocate Community Income based on Federal Law[129]

Under our proposal, each spouse would only be subject to tax on the income under his or her control. The rules for allocating a nonresident alien's income under IRC § 879(a) (described above) would apply to all couples, with slight modification. IRC § 879 is similar to the existing income allocation rules applicable in every state except the nine community property law states.

Tax Income to the Person with Control

Our proposal would modify the current rule under IRC § 879 that "other income" such as investment income, is allocated to the spouse with a "proprietary vested interest" under local law.[130] Under that rule, for example, if a husband holds stock that is community property, any dividends paid on the stock may be taxed one-half to the wife.[131] Under our proposal, "other income" would be taxed to the person with the power to dispose of it, which is generally the person holding title to the asset generating the income. The income would be taxed one-half to each spouse only if each spouse had equal power to dispose of it under local law. This proposal will help to ensure that a taxpayer is not taxed on income he or she does not control.

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128 A simple form of the existing rules may be useful in rare cases, for example, to address situations where the allocation shown on a joint tax return is the product of abuse but not duress. *See* Treas. Reg. § 1.6015-3(c)(2)(v) (eliminating the "no actual knowledge" requirement if abuse caused the requesting spouse not to challenge the treatment of an item on the joint return).

129 *Poe v. Seaborn*, 282 U.S. 101 (1930).

130 *See* IRC § 879(a)(4); Treas. Reg. § 1.879-1(a)(6).

131 *See* Treas. Reg. § 1.879-1(a)(7)(Ex. 7).

Simplify the Code

Many Code provisions specifically override community property rules, as noted above. Thus, by repealing *Seaborn* and imposing one standard income allocation rule, Congress could significantly simplify the Code because each specific carve-out could be removed as unnecessary.

Collect from Liable Spouse First

Under our proposal, the IRS would be required to exhaust all reasonable efforts to collect against the assets under the liable spouse's control before collecting against assets under the nonliable spouse's control.[132] This requirement would require the IRS to collect only from the "right" spouse whenever possible, and help prevent collection efforts from undermining the other proposed changes.

132 This proposal is only relevant to collection in community property jurisdictions where the IRS can collect one spouse's liabilities from assets under the nonliable spouse's control.

5 KEY LEGISLATIVE RECOMMENDATION: REQUIRING BROKERS TO TRACK AND REPORT COST BASIS FOR STOCKS AND MUTUAL FUNDS

PROBLEM

When taxpayers sell mutual fund shares or stock holdings, they generally are required to report the net gain or loss on the transaction on their federal income tax returns.[1]

If the proceeds a taxpayer receives upon a sale exceed his "adjusted basis" in the asset, the taxpayer recognizes a gain.[2] If the proceeds the taxpayer receives upon the sale are less than his "adjusted basis" in the asset, the taxpayer recognizes a loss.[3] Because taxpayers are required to report transactions in the year of sale, they generally have very little difficulty determining the amount of the proceeds they received from the sale. Moreover, where the shares are publicly traded, brokers are required to report the gross sales proceeds on Form 1099-B, Proceeds From Broker and Barter Exchange Transactions.

The determination of "adjusted basis," however, can be much more challenging for two main reasons. First, the original purchase may have occurred years in the past and the taxpayer may no longer have a record of the date of purchase, the number of shares purchased, or the original cost of the asset. Indeed, the taxpayer may have received the shares as a gift or by inheritance.[4] Second, the "adjusted basis" required for tax reporting is not merely the taxpayer's original cost. The taxpayer's adjusted basis often reflects multiple transactions that have occurred since the original purchase date.

In the case of stocks, basis is affected by stock splits, mergers, and other corporate reorganizations. In the case of mutual funds, taxpayers typically elect to have dividend and capital gain distributions automatically reinvested, and each such distribution constitutes a taxable event in the year of occurrence and gives rise to an offsetting increase in the taxpayer's aggregate adjusted basis to prevent a second round of taxation when the taxpayer ultimately sells the mutual fund.

Under current law, financial institutions are not required to keep track of the adjusted basis of stocks and mutual funds for investors (although many do so for customer service reasons). In addition, an investor who holds an asset in an account at one financial institution may move his account to another financial institution, perhaps because the other institution charges lower fees or pays a higher rate of interest on cash deposits. Although an investor may elect to have the entire account, including stocks and mutual funds, transferred directly from one financial institution to another, records regarding the taxpayer's adjusted basis are not currently transferred.

1 Sales of assets held in tax-exempt accounts, such as qualified retirement accounts or Section 529 plans, generally are not subject to taxation.

2 IRC § 1001(a).

3 *Id.*

4 The tax rules applicable to the receipt of stock by gift or inheritance are discussed in the Explanation of Recommendations, *infra.*

The absence of accurately maintained and reported information imposes significant compliance burdens on taxpayers, because taxpayers are required to report cost basis information on their tax returns. The absence of accurately maintained and reported information also provides opportunities for deliberate noncompliance. Because sophisticated taxpayers know that their adjusted basis generally is not reported to the IRS, some consciously overstate their basis in order to reduce their reported gains or to claim losses.

EXAMPLES

1. Mutual Funds: Automatically Reinvested Dividends and Capital Gains

A taxpayer invested $10,000 in a mutual fund on January 2, 1992, and elected to have all dividend and capital gain distributions automatically reinvested in the fund. In each subsequent year, the fund made at least one dividend distribution and at least one capital gain distribution. The taxpayer also had directed that 10 percent of each monthly paycheck he received between 1992 and 1997 be deposited into the fund. He withdrew funds on two occasions – once for a home purchase and once when he purchased a car. On December 16, 2005, the taxpayer sold his position in the mutual fund for $40,000.

On his 2005 tax return, the taxpayer will be required to report as a net gain or loss the excess of the proceeds he received upon the sale ($40,000) over his aggregate adjusted basis. If the taxpayer held the mutual fund through a single financial institution that kept track of the basis for him, he is in luck. But if the financial institution did not keep track of the basis or if the taxpayer transferred the holding from one financial institution to another during his 14-year holding period, the taxpayer will need records for each of the past 14 years to compute his basis and it will not be easy to do. The taxpayer's aggregate adjusted basis in the fund changed each time he received a dividend or capital gain distribution (he received at least 28 such distributions), each time 10 percent of his monthly paycheck was deposited into the fund over a five-year period (60 investments), and each time he made a withdrawal (twice).[5]

If the taxpayer no longer has all of his records, it will be impossible for the taxpayer to compute his adjusted basis.

2. Mutual Funds: Frequent Withdrawals from Bond Funds

Today, some large financial institutions allow investors to write checks against monies invested in bond mutual funds. Because bond funds typically pay higher rates of interest than stable-dollar money market funds, this is an attractive option for many middle-income investors. Assume an investor has a portion of his paycheck automatically deposited into a short-term bond fund and he pays his monthly mortgage by writing a check against that fund.

[5] The taxpayer's withdrawals for the home purchase and automobile purchase were also taxable events in the years in which they occurred.

While this approach may be optimal from a financial standpoint, it creates considerable complexity from a tax standpoint. Each time a portion of the paycheck is deposited into the fund, it is considered an investment that increases his aggregate adjusted basis. Each time the taxpayer pays his mortgage by writing a check on the account, the payment is considered a taxable withdrawal. Thus, the taxpayer in this example will have to report 12 taxable events during the year and determine the adjusted basis at the time of each of those 12 withdrawals.

If the taxpayer holds the bond mutual fund for many years and the fund does not keep adequate track of the taxpayer's basis, it will be very difficult for the taxpayer to reconstruct his basis even if he has retained complete records and impossible for the taxpayer to reconstruct his basis if his records are incomplete.

3. Stocks: Stock Splits and Reorganizations

In 1983, AT&T was the most widely held stock in the United States. Assume a taxpayer purchased 100 shares of AT&T stock on January 3, 1983, at a price of $60 per share and sold the stock on December 13, 2005, at a price of $25 per share. An unsophisticated taxpayer might assume that the value of the company's stock declined from $60 to $25 during the past 22 years and might report a loss of $3,500 (*i.e.*, $35 loss per share multiplied by the 100 share initial purchase).

In fact, the computation of the taxpayer's basis is far more complex:[6]

On January 1, 1984, AT&T divested of its local phone service operations and distributed the stock of seven newly formed regional phone companies to its shareholders. Each AT&T shareholder received one share in each new company (Ameritech, Bell Atlantic, Bell South, NYNEX, Pacific Telesis, Southwestern Bell, and U.S. West) for every ten shares of AT&T owned. Prior to that date, the taxpayer's basis in AT&T stock had been $6,000 (i.e., the $60 per share purchase price multiplied by the 100 shares purchased). As a result of the spin-offs, 28.5 percent of the taxpayer's basis remained with the AT&T shares. Thus, the taxpayer's new basis in his AT&T stock was $1,710. The remaining basis was allocated among the seven regional Bell companies in varying percentages totaling 71.5 percent.

On September 30, 1996, AT&T spun off newly formed Lucent Technologies and distributed 0.324084 shares of Lucent common stock for each share of AT&T owned. As a result of the spin-off, 72.01 percent of the taxpayer's basis remained with the AT&T shares. Thus, the taxpayer's new basis in his AT&T stock was $1,231.37. The remaining basis was allocated to the taxpayer's new holding of Lucent stock.

On December 31, 1996, AT&T spun off newly formed NCR Corporation and distributed 0.0625 shares of NCR common stock for each share of AT&T owned. As a result of the spin-off, 95.23 percent of the taxpayer's basis remained with the AT&T shares.

[6] These adjustments are described on the AT&T corporate website.

Thus, the taxpayer's new basis in his AT&T stock was $1,172.63. The remaining basis was allocated to the taxpayer's new holding of NCR stock.

On April 15, 1999, AT&T implemented a 3 for 2 stock split. As a result, the taxpayer's aggregate basis in AT&T stock remained $1,172.63, but the number of shares he held increased from 100 shares to 150 shares.

On July 9, 2001, AT&T split off newly formed AT&T Wireless Services and distributed 0.3218 shares of AT&T Wireless Services common stock for each share of AT&T owned. As a result of the split-off, 77.66 percent of the taxpayer's basis remained with the AT&T shares. Thus, the taxpayer's new basis in his AT&T stock was $910.66. The remaining basis was allocated to the taxpayer's new holding of AT&T Wireless Services stock.

On November 18, 2002, two transactions occurred. First, AT&T entered into a stock transaction with Comcast Corporation and distributed to its shareholders 0.3235 shares of Comcast common stock for each share of AT&T owned. As a result of the transaction, 37.4 percent of the taxpayer's basis remained with the AT&T shares. Thus, the taxpayer's new basis in his AT&T stock was $340.59. The remaining basis was allocated to the taxpayer's new holding of Comcast stock. On the same date, AT&T implemented a reverse 1 for 5 stock split. As a result, the taxpayer's aggregate basis in AT&T stock remained $340.59, but the number of shares he held declined from 150 shares to 30 shares.

On November 18, 2005, AT&T merged with SBC Communications. As a result of the transaction, the taxpayer received 0.77942 shares of new AT&T stock for each share of AT&T stock he owned previously. Thus, the number of shares he held declined from 30 shares to 23 shares, and he received cash in lieu of a 0.3826 fractional share. The amount of the cash payment, $5.57, reduced the taxpayer's basis in his AT&T stock from $340.59 to $335.02.

As a result of all these transactions, the taxpayer should properly report a loss of $239.98 upon the sale of his entire AT&T stock holding. This represents his proceeds of $575 (23 shares x $25 sales price) reduced by his basis of $335.02.

Note that the taxpayer in this example acquired stock in 11 additional companies directly – and most of them engaged in subsequent corporate restructurings – and the taxpayer ultimately likely will need to compute his basis in each of those companies' stock. In addition, if the taxpayer did not keep a record of his original purchase or received the shares as a gift, he would have no idea where to begin.

This example is not atypical. Corporate restructurings and stock splits occur daily in the marketplace. Moreover, 3.2 million shareholders owned AT&T stock in 1983, so many taxpayers have faced the need to reconstruct their basis in AT&T and its distributed companies as described in this example.

4. Tax Cheating Via Overstatement of Basis

On January 2, 1987, a taxpayer purchased 100 shares of Microsoft Corporation at $47.75 per share. His aggregate basis therefore was $4,775. On December 5, 2005, the taxpayer sold his position at $28 per share. Due to eight stock splits, however, the taxpayer now held 28,800 shares. Thus, the proceeds from his sale (leaving aside trading costs) came to $806,400. His net gain (*i.e.*, the difference between his proceeds and his basis) was $801,625.

Because there is no requirement that brokers track and report basis to the IRS, the taxpayer might be tempted to overstate his basis. For example, he might indicate that he purchased 28,800 shares on September 26, 2003, when the stock was selling for $30 per share, giving him a cost basis of $864,000. Therefore, instead of reporting a gain of $801,625, he would report a loss of $57,600 (*i.e.*, basis of $864,000 reduced by proceeds of $806,400). Unless the IRS were to audit this taxpayer, the IRS would probably not detect this misstatement.

RECOMMENDATIONS

Amend Internal Revenue Code § 6045(a) to authorize the Secretary of the Treasury to prescribe regulations that require brokers to report information not only regarding gross proceeds but also regarding adjusted basis in connection with the sale of mutual funds and stocks.

To facilitate accurate basis reporting, financial institutions that hold mutual funds or stock for customers should, when a customer transfers assets to a successor financial institution, be required to provide the customer's adjusted basis in the transferred mutual fund and stock holdings to the successor financial institution.

CURRENT LAW

Information Reporting

Section 6045(a) of the Internal Revenue Code currently requires brokers to provide information returns showing the name and address of each customer along with details regarding gross proceeds and such other information as the Secretary may require.

Computation of Basis

Section 1011 provides generally that the adjusted basis for determining gain or loss from the sale or other disposition of property is the cost of the property, as described in Section 1012, subject to certain adjustments, as described in Section 1016.

For purposes of computing basis, Treasury regulations set forth several methods that may be used. If a taxpayer purchased all shares of a stock at the same price and later sells some of the shares, there is no ambiguity about the cost basis because there was only one purchase price. If a taxpayer purchases stock at different prices and later sells some but not all of the shares, however, his basis will vary depending on which of the shares he is treated as having sold. The method of determining the cost basis of the shares sold depends on whether it is possible to identify the specific lot from which the shares were originally purchased. If the specific lot cannot be adequately identified, the default method under the regulations is to treat the shares sold as coming from the earliest lots purchased or acquired. This is sometimes referred to as the "first in, first out," or "FIFO," method. If the specific lot can be adequately identified, then the shares sold will be treated as coming from that lot.[7]

In the case of mutual funds, two additional methods are available that are designed to measure "average basis." One is referred to as the "single-category method," and the other is referred to as the "double-category method."[8] The mechanics of these alternative methods are described in detail in the regulations.

REASONS FOR CHANGE

Taxpayer Burden

Today, more Americans own stocks, either directly or through mutual funds, than ever before. According to a 2005 survey conducted jointly by the Investment Company Institute (ICI) and the Securities Association of America (SEA), the number of households owning stocks or mutual funds has more than tripled since the early 1980s, rising from 16 million households in 1983 to 57 million households in 2005.[9] While much of the growth in equity ownership has occurred in tax-exempt retirement plans, the survey found that about 31 million households own mutual funds or stocks in taxable accounts.[10]

Many of these 31 million households do not maintain adequate records of stock and mutual fund holdings over multi-year periods to determine basis, and many taxpayers that do maintain adequate records nonetheless have difficulty making the complex computations required to determine their basis.

As illustrated in the Examples above, most mutual fund investors elect to have their dividend and capital gain distributions automatically reinvested in their funds, causing their aggregate adjusted bases to change upon each such reinvestment. Many mutual fund investors also make periodic investments in or withdrawals from the fund, and each of these events also causes their aggregate adjusted basis to change. Many mutual fund companies assist their investors by keeping track of adjusted basis, but some do not.

With regard to stock investors, most brokers keep track of purchases their customers

7 Treas. Reg. § 1.1012-1(c).

8 Treas. Reg. § 1.1012-1(e).

9 Investment Company Institute & Securities Industry Association, *Equity Ownership in America, 2005,* at 1 (Figure 1).

10 *Id*. at 9 (Figure 12) and 15.

make, but they do not necessarily update their basis records to reflect stock splits, spin-offs, and other corporate restructurings.

For both mutual fund and stock investors, a particularly significant problem arises when an investor transfers assets from one financial institution to another. The transferring broker does not provide information about the investor's basis to the transferee broker. Therefore, to the extent that many investors rely on their financial institution to track their adjusted basis in their holdings, they are no longer able to rely on the financial institution's records after an asset transfer. This problem is almost surely arising with increasing frequency, because the accessibility of low-cost brokerage firms via the Internet enables investors to shop around for the lowest commissions and the highest interest rates. As a consequence, the transfer of assets from one financial institution to another is now commonplace.

While taxpayers are properly required to keep adequate records to substantiate their tax reporting, the reality is that some investors hold stocks or mutual funds for decades, and it is simply not realistic to expect that all taxpayers will keep perfect records for long periods of time. Even where a taxpayer does keep complete records, the task of computing changes in adjusted basis can be overwhelming. This is particularly true for mutual fund investors who must make multiple adjustments each year for investments, withdrawals, and automatically reinvested dividend and capital gain distributions and for investors in stocks that undergo stock splits and corporate restructurings, as illustrated by Example 3 above involving an investor in AT&T stock.

Revenue Protection

The IRS Research function recently updated its findings regarding the magnitude and sources of the tax gap. The results confirm what earlier studies have found: When transactions are subject to information reporting to the government, tax compliance is generally very high – well over 90 percent. However, when transactions are not subject to information reporting to the government, the tax compliance rate drops precipitously to a range of about 20 percent to about 68 percent, depending on the type of transaction.[11]

As illustrated in Example 4, the opportunity for noncompliance upon the sale of mutual funds or stocks is considerable under current law, because the taxpayer's basis is not reported to the government. IRS data for Tax Year 2003 show that nearly 30 million taxpayers filed Form 1040, Schedule D, "Capital Gains and Losses,"[12] and in a recent article published in Tax Notes, Professors Joseph Dodge and Jay Soled estimate that noncompliance in this area will come to about $250 billion over the next 10 years and could be higher.[13]

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[11] IRS National Headquarters, Office of Research, July 2004.

[12] IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2003).

[13] Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Billion-Dollar Revenue Question,* 106 Tax Notes 453 (Jan. 24, 2005).

A basis-reporting requirement should virtually eliminate this source of noncompliance.

EXPLANATION OF RECOMMENDATIONS

Requiring financial institutions to track and report adjusted basis to taxpayers and the IRS is a win-win proposition for taxpayers and the government. Taxpayers will no longer have to struggle with attempting to reconstruct their basis in assets they have sold during the year, and the government will be able to collect the proper amount of tax due on such sales.

As a threshold matter, we note that the Secretary of the Treasury probably has the authority to require brokers to report adjusted basis under existing law. Section 6045 of the Internal Revenue Code authorizes the Secretary to prescribe regulations requiring brokers to make a return showing details "regarding gross proceeds *and such other information as the Secretary may by forms or regulations require*." (Emphasis added.) In our view, the term "such other information" is broad enough to encompass adjusted basis. However, opponents of this proposal might argue that because Section 6045 specifically mentions gross proceeds but does mention adjusted basis, Congress did not intend to give Treasury authority to require that basis information be reported. For that reason, and because requiring basis reporting could be controversial, we believe it would be helpful for Congress to amend Section 6045 to clarify the Secretary's authority to require basis reporting.

In writing regulations to require reporting of adjusted basis, there are some technical issues that would need to be worked out.

One issue involves how reporting would work in light of the multiple basis-computation methods currently authorized by Treas. Reg. § 1.1012-1. With respect to stocks, the FIFO method is generally used by default unless an investor provides prior notice to the broker that he or she wants to use the specific identification method. With respect to mutual funds, virtually all financial institutions that track basis for their customers use an average-cost method. Treasury could require brokers to track and report adjusted basis in light of these rules and practices and then allow a taxpayer to elect to use an alternative method by submitting an explanation with his return. We note that the existing basis-computation methods are regulatory, not statutory, so Treasury could modify these methods as it deems appropriate.

A second issue involves how a broker would address situations where stocks or mutual funds are transferred by gift or upon death. Where capital assets are transferred by gift, the recipient generally takes a carryover basis in the asset but is limited in his or her ability to claim losses attributable to periods before receiving the gift.[14] Where capital assets are transferred upon the owner's death, the recipient currently receives a step-up

[14] IRC § 1015(a).

in basis as of the holder's date of death or alternate valuation date.[15] When mutual funds or stocks are transferred from the account of the original owner to the account of a successor owner, then, the broker would need to receive paperwork documenting sufficient details about the transfer to continue to track the holder's basis accurately.

A third issue involves the technological modifications brokers would be required to make to their computerized record systems to ensure that they can accurately track and report basis. The technology to do this clearly exists, and brokers already transfer considerable information when customers move their stock or mutual fund holdings from one broker to another. At the same time, we acknowledge that financial institutions would incur some costs in implementing this proposal. Depending on the cost estimates, Congress could consider providing brokers with a one-time credit to offset the expenses of implementing the requirements of this proposal. If the revenue gains to the government are anywhere close to Professor Dodge & Soled's estimate of $250 billion over 10 years, a modest credit would pay for itself quickly and many times over.

The National Taxpayer Advocate believes these technical issues are resolvable and that a basis-reporting requirement would ultimately benefit all honest taxpayers – both taxpayers who face daunting challenges in computing their basis and taxpayers who are paying more in taxes to subsidize noncompliance by those who overstate their basis and thereby fail to pay their fair share.

[15] IRC §§ 1014(a)(1) & 2032(a). The federal estate tax has been repealed effective in 2010. As part of that change in law, some recipients of inherited stock will assume the decedent's basis (*i.e.*, they will not receive a step-up in basis). They therefore will need to determine the basis the decedent held in the asset. For a discussion of the impact this change may have on taxpayers, *see* Key Legislative Recommendation: *Tracking Cost Basis as a Result of Estate Tax Repeal, infra.*

6 KEY LEGISLATIVE RECOMMENDATION: TRACKING COST BASIS AS A RESULT OF ESTATE TAX REPEAL

PROBLEM

Under the current estate tax regime, the basis of property in the hands of a person acquiring property from a decedent is, generally, the fair market value (FMV) of the property at the date of the decedent's death.[1] This basis is commonly referred to as a "step-up" in basis. When the estate tax is repealed for 2010, such persons will no longer receive a step-up in basis. Instead, property acquired from a decedent dying after December 31, 2009, will be treated as transferred by gift, and the basis of the person acquiring the property from such a decedent will be the lesser of the decedent's adjusted basis or the FMV of the property at the date of the decedent's death.[2] This rule has been referred to as the "modified carryover basis rule."

Requiring modified carryover basis calculations places an inordinate burden on taxpayers. Even the most conscientious taxpayers may find it impossible to reconstruct the basis of property that was passed on from generation to generation. Moreover, the modified carryover basis rules are projected to apply to 71,400 estates in contrast to the 7,500 expected to face estate tax liability under the rules for 2009, thereby shifting the burden of the estate tax from 0.3 percent of estates to 2.9 percent – in other words, multiplying its impact nearly tenfold.[3] Congress should explore ways to lessen the compliance burden of this unintended consequence of the estate tax repeal.

EXAMPLE

An unmarried man dies in 2009, leaving behind $3 million in property and an aggregate basis in the property of $500,000. In 2009, estates under $3.5 million in property will not pay any estate tax. The person acquiring the property would receive a step-up in basis to $3 million (the FMV of the property at the decedent's date of death). Essentially, this person could sell all the property immediately and receive $3 million free of tax.

Now assume the same man dies in 2010, when the estate tax is repealed. The person acquiring the property would be limited to a basis increase of $1.3 million, bringing the aggregate basis increase up to $1.8 million ($500,000 aggregate adjusted basis plus $1.3 million aggregate basis increase). If this person decides to sell all the property at that point for $3 million, he would be required to pay capital gains tax on the gain of $1.2

[1] *See* IRC § 1014(a).

[2] *See* IRC § 1022(a).

[3] The Census Bureau estimates that approximately 2.5 million persons will die during 2009 in the United States. The Joint Committee on Taxation (JCT) estimates that the estates of approximately 7,500 persons who die during 2009 will have an estate tax liability under current law. The JCT further estimates that the estates of 71,400 persons who die during 2009 will have estates worth in excess of $1.3 million. *See* John Buckley, *Estate Tax Repeal: More Losers than Winners,* 2005 TNT 30-17 (Feb. 14, 2005); *see also* Tax Policy Center, *Table T05-0151, $3.5 Million Exemption Indexed for Inflation After 2010 and 45 Percent Rate: Distribution of Gross Estate and Net Estate Tax by Size of Gross Estate, 2011* (July 25, 2005).

million ($3 million FMV less $1.8 million basis). Furthermore, if this person does not readily know the decedent's adjusted basis in the property, he will be forced to reconstruct the adjusted basis for transactions that may have occurred decades ago.

RECOMMENDATION

The National Taxpayer Advocate does not endorse any specific proposal to remedy this problem. Rather, she encourages Congress to examine this issue and explore alternatives that would ease the compliance burden for taxpayers.

Possible solutions include:

- Increasing the amount that executors may elect to apply to step-up basis to exclude more taxpayers from modified carryover basis calculations;
- Requiring brokerage firms and mutual fund administrators to track basis; or
- Reverting to the pre-EGTRRA (Economic Growth and Tax Relief Reconciliation Act) rules with indexing of applicable exclusion amounts.

PRESENT LAW

The United States has had an estate tax since 1916.[4] The estate tax is calculated as a percentage of the part of the estate that exceeds the applicable exclusion amount. Under current law, the applicable exclusion amount will increase steadily from $1.5 million in 2005 to $3.5 million in 2009.[5] For estates that exceed the applicable exclusion amount, an estate tax is calculated using the applicable rates (for 2005, rates ranged from 43 percent to 47 percent).

Lawmakers have amended the Internal Revenue Code many times, lowering or raising the applicable rate and increasing or decreasing the applicable exclusion amount for estate tax purposes. Most recently, the Economic Growth and Tax Relief Reconciliation Act of 2001[6] (EGTRRA) reduced estate tax rates and increased the applicable exclusion amounts from 2002 through 2009. The EGTRRA eliminates the estate tax altogether in 2010. In 2011, the EGTRRA is scheduled to expire, and the estate tax rates and exemption amounts will revert back to pre-EGTRRA levels.

[4] Congressional Budget Office, *Effects of the Federal Estate Tax on Farms and Small Businesses* 1 (July 2005).

[5] *See* IRC § 2010(c).

[6] Pub. L. No. 107-16, June 7, 2001.

TABLE 2.6.1, SCHEDULED CHANGES IN TAX RATES AND APPLICABLE EXCLUSION AMOUNTS FOR ESTATE AND GIFT TAXES UNDER EGTRRA

Year	Lowest Tax Rate (%)	Highest Tax Rate (%)	Applicable Exclusion Amount (Millions of $)
2002	41	50	1.0
2003	41	49	1.0
2004	43	48	1.5
2005	43	47	1.5
2006	45	46	2.0
2007	45	45	2.0
2008	45	45	2.0
2009	45	45	3.5
2010	0	0	n/a
After 2010	41	55/60[7]	1.0

The appreciation in value of property is generally subject to tax only when the asset is sold.[8] For income tax purposes, "adjusted basis" is the term used to describe the amount paid for property, plus or minus a variety of adjustments such as improvements or depreciation.[9] When property is sold, the adjusted basis is subtracted from the sale price to compute taxable gain or loss.[10]

One significant adjustment to basis relates to property acquired from a decedent. The adjusted basis of property acquired from a decedent is generally "stepped up" to FMV at the date of death.[11] For example, if a decedent passes property on to another person, the property's basis is stepped up to its FMV *at the date of the decedent's death*. In situations where appreciated property is held until death, the appreciation in value of the property from acquisition until death escapes taxation.

However, when the estate tax is repealed in 2010[12], a person acquiring property from a decedent must determine the modified carryover basis of the property. Under the modified carryover basis rules, the basis of the property is increased by its basis increase, which is defined as a portion of the aggregate basis increase allocated to the property.

[7] Estates valued at $10 million to $17.184 million are subject to a maximum tax rate of 60 percent in order to eliminate the value of the exempt amount of assets. Estates valued at more than $17.184 million are taxed at an average rate of 55 percent.

[8] *See* IRC §§ 1001, 1014.

[9] *See* IRC §§ 1011, 1012.

[10] *See* IRC § 1001(a).

[11] *See* IRC § 1014(a).

[12] Under current law, the estate tax is to be repealed for year 2010 only, as EGTRRA is set to expire in 2011 and the pre-EGTRRA estate tax regime is to be reinstated.

The aggregate basis increase is $1.3 million.[13] A person acquiring property from a decedent will use the modified adjusted basis (carryover basis plus basis increase) to determine gain or loss on the sale of the property.

REASONS FOR CHANGE

Due to the scheduled increases in applicable exclusion amounts, the estate tax will affect only the estates of the wealthiest Americans. Recent estimates show that by 2009 just the top 0.3 percent of estates will be required to pay the tax.[14] Put another way, 997 of every 1000 families would be unaffected by the estate tax if the current estate tax laws did not change from 2009 to 2010.

Ironically, the estate tax repeal that looms in 2010 will have a significant adverse affect on a far greater number of taxpayers. Individuals who acquire property from a decedent may no longer use stepped-up basis to compute gain or loss on the sale of property acquired from a decedent.[15]

Determining a decedent's adjusted basis in property is no easy chore. Even taxpayers who have kept impeccable records on their own properties may find it impossible (or at least impracticable) to reconstruct the records of the decedent to arrive at an accurate calculation of a decedent's adjusted basis. This task will be especially difficult if the decedent had not anticipated the need to retain records of amounts paid and basis adjustments.

For example, suppose Taxpayer A purchased 100 shares of stock in AT&T in 1970. If Taxpayer A dies in 2010, the stock will pass on to Taxpayer B. When Taxpayer B subsequently disposes of the stock, he must use Taxpayer A's adjusted basis, plus a portion of the aggregate basis increase, in calculating gain or loss on the transaction. Given that more than 40 events have affected the cost basis of AT&T stock since 1984 alone (including stock splits, reverse stock splits, spin-offs, distributions, and reacquisition of previously spun-out assets)[16], it is unlikely that Taxpayer A retained all the paperwork that reflected basis adjustments through the years and passed it on to Taxpayer B in an easily accessible, understandable manner.

Reconstructing adjusted basis in property is difficult enough while taxpayers with such assets are alive; after death, it becomes next to impossible. Furthermore, where the property is something other than publicly traded stock, the prospect of finding docu-

13 IRC § 1022(b)(2)(B). For property passed on to a surviving spouse, an executor will be allowed to increase the adjusted basis of property by the aggregate spousal property basis increase of $3 million. *See* IRC § 1022(c)(2).

14 Center on Budget and Policy Priorities, *Estate Tax Reform, Rather than Repeal, Could Preserve Much Needed Revenues and Help Restore Social Security Solvency 3-4* (Apr. 12, 2005).

15 *See* IRC § 1014(f).

16 *See* XciTax, *AT&T Cost Basis: A Case Study* (Feb. 2005), available at http://xcitax.com/attcasestudy.pdf. For further discussion of the difficulties in tracking AT&T stock basis, *see* Key Legislative Recommendation: *Requiring Brokers to Track and Report Cost Basis for Stocks and Mutual Funds, supra.*

mentation substantiating basis is even less likely.

EXPLANATION OF RECOMMENDATION

The impending estate tax repeal will have significant (and likely unintentional) consequences for many taxpayers. Taxpayers who receive distributions from an estate with greater than $1.3 million in property (projected to be 2.9 percent of estates by 2009[17]) may no longer use the stepped-up basis for property acquired from a decedent. Once the estate tax is repealed, these taxpayers must use the modified carryover basis, which may require extremely complex calculations to determine the property's adjusted basis in the hands of the decedent just prior to death, and then allocate a portion of the aggregate basis increase to that property to determine the property's basis in the hands of the person acquiring the property from the decedent.

The National Taxpayer Advocate does not believe it was the intent of Congress to impose such an onerous requirement on such a large segment of the population. She urges Congress to revisit this issue and explore less burdensome alternatives.

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17 *See* John Buckley, *Estate Tax Repeal: More Losers than Winners*, 2005 TNT 30-17 (Feb. 14, 2005).

7 KEY LEGISLATIVE RECOMMENDATION: RESTRUCTURING AND REFORM OF COLLECTION DUE PROCESS PROVISIONS

PROBLEM

For the last three years, the National Taxpayer Advocate has identified weaknesses in the IRS's Collection Due Process (CDP) hearing program.[1] CDP hearings afford taxpayers the opportunity to ask for a meaningful review of certain IRS collection actions by an impartial officer of the IRS Office of Appeals (Appeals) at two separate points in the collection process: after the initial filing of a federal tax lien and prior to an initial levy of the taxpayer's assets.[2] The CDP process, which includes the right to judicial review, stays some collection actions but not others.[3] Thus, CDP rights provide important protections to taxpayers. As we and others have noted, however, there are shortcomings to the CDP legislation.[4] CDP rights are both under-inclusive and over-inclusive,[5] denying judicial review of some lien and levy actions while encouraging counterproductive behavior on the part of other taxpayers and on the part of the IRS.

CDP rights are under-inclusive because taxpayers can only seek CDP's protections once following the first Notice of Federal Tax Lien issued with respect to a particular tax for a particular period,[6] and once upon issuance of the first Notice of Intent to Levy with respect to that tax.[7] Thus, CDP provides a snap-shot of a taxpayer's financial situation at one point in a collection process that is fluid.[8] For example, taxpayers do not receive

1 *See* National Taxpayer Advocate 2002 Annual Report to Congress 110 (addressing taxpayer's confusion about the CDP process and delays in Appeals); *see also* National Taxpayer Advocate 2003 Annual Report to Congress 38 (addressing Most Serious Problem of delays in CDP hearings); and National Taxpayer Advocate 2004 Annual Report to Congress (making Key Legislative Recommendation to eliminate *de novo* review of the underlying liability and also making administrative recommendations to improve the hearing process and better educate taxpayers about what can be achieved in the hearing process).

2 IRC § 6320(b) governs a taxpayer's right to a CDP hearing after the filing of the first federal tax lien with respect to a tax liability, and IRC § 6330(b) governs a taxpayer's right to a CDP hearing prior to the first levy on the taxpayer's property with respect to that liability.

3 CDP hearings occur post-issuance of the Notice of Federal Tax Lien, and thus, do not bar the IRS from perfecting its security interest in assets of the taxpayer. IRC § 6320(a)(2). If taxpayers timely elect CDP hearings, levy action will be stayed until the completion of the hearing unless the IRS determines that collection of the tax is in jeopardy. IRC § 6330(e)(1) and (f)(1). Additionally, the IRS can levy while a case is on appeal before a court if it can demonstrate "good cause." IRC § 6330(e)(2).

4 Leslie Book, *The Collection Due Process Rights: A Misstep or a Step in the Right Direction?*, 41 Hous. L. Rev. 1145, 1148 (2004); *see also* Bryan T. Camp, *Failure of Collection Due Process*, Pt. 1: *The Collection Context*, 104 Tax Notes 969 (Aug. 30, 2004); Bryan T. Camp, *The Failure of CDP, Part 2: Why it Adds No Value*, 104 Tax Notes 1567 (Sept. 27, 2004); Bryan T. Camp, *The Costs of CDP*, 105 Tax Notes 1445 (Dec. 6, 2004); Bryan T. Camp, *Replacing CDP*, 107 Tax Notes 1039 (May 23, 2005); Dashera Cords, *Reforming Not Replacing CDP*, 108 Tax Notes 817 (Aug. 15, 2005); Dashera Cords, *Collection Due Process: The Scope and National of Judicial Review*, 73 U. Cin. L. Rev. 1021 (2005); Diane L. Fahey, *The Tax Court's Jurisdiction over Due Process Collection Appeals: Is It Constitutional*, 55 Baylor L. Rev. 453 (2003).

5 Leslie Book, *The Collection Due Process Rights: A Misstep or a Step in the Right Direction?*, 41 Hous. L. Rev. 1145, 1203 (2004).

6 IRC § 6320(b)(2).

7 IRC § 6330(a)(1).

8 Bryan T. Camp, Replacing CDP, 107 Tax Notes 1039 (May 23, 2005).

CDP's protections for subsequent levies after the taxpayer's financial condition may have worsened, or where the IRS later denies viable collection alternatives, or where the IRS refuses or otherwise fails to release levy proceeds.[9]

CDP rights are also over-inclusive in two important respects. First, CDP allows some taxpayers to contest their underlying liability before Appeals and in *de novo* judicial review proceedings on appeal from Appeals' determination, even where the taxpayer self-assessed the liability.[10] Second, some taxpayers use the CDP process to raise frivolous issues or *solely* for the purpose of delaying levy action. Some believe that CDP deprives the IRS Collection function of valuable leverage in getting taxpayers to pay delinquent taxes. That is, the taxpayer can respond to a proposed levy action by electing a CDP hearing and remove the collection case from the control of IRS Collection personnel and into Appeals, and the courts, for an extended period of time.

EXAMPLE

> Taxpayer A has an unpaid tax liability from the tax year 2003, for which he previously received a CDP notice. Instead of requesting a CDP hearing, taxpayer entered into an installment agreement. Taxpayer A's financial position changes for the worse and he decides to submit an offer in compromise in order to resolve the tax problem once and for all. Taxpayer A files his offer for $2,400 to be paid in $100 monthly installments, and the offer is processed through the IRS's Centralized Offer in Compromise Program (COIC). In justifying the amount that the taxpayer can pay, the taxpayer provides records of actual expenses in the amount of $3,989. While reviewing the offer, however, the IRS offer specialist uses national expense standards of $4,644 and rejects the offer, concluding that the taxpayer cannot make the payments. The taxpayer appeals the specialist's determination to the Office of Appeals in a non-CDP appeal pursuant to IRC § 7122(d); however, the Appeals officer comes to the same conclusion and the offer is rejected. The taxpayer has no further recourse.

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9 *See* IRC § 6343(d)(2).

10 Leslie Book, *The Collection Due Process Rights: A Misstep or a Step in the Right Direction?*. 41 Hous. L. Rev. 1145, 1188-1190, (2004) noting:

> One important way to limit CDP costs and to address the over inclusive nature of CDP as it is currently written is to eliminate or reduce the opportunities a taxpayer has to challenge his underlying liability in CDP hearings… Even if Congress is unwilling to eliminate the liability category completely, it should legislatively overrule *Montgomery v. Commissioner*, which held that taxpayers can challenge the amount or existence of a liability in a CDP hearing even if the liability arises from filing a tax return with an unpaid liability.

> Taxpayer B has the same facts as Taxpayer A except that Taxpayer B receives a *Notice of Intent to Levy and Your Right to a Hearing*. Taxpayer B elects his right to a CDP hearing and submits his offer as a collection alternative at the CDP hearing. The Appeals officer applies the higher national expense standards, rather than utilizing the taxpayer's actual expenses. In response to the Notice of Determination from Appeals rejecting the offer, Taxpayer B files a petition in the Tax Court, which holds that it was an abuse of discretion for the Appeals officer to have rejected the offer in compromise under the circumstances.[11]

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations to retain and enhance taxpayer protections in the tax collection process while ensuring that the IRS's ability to collect the correct amount of tax is not unreasonably impaired.

- Amend IRC §§ 6330(a)(2) and (a)(3)(C) to require the IRS to issue the CDP levy notice at the time it undertakes its first levy action with respect to a tax. Such notice shall describe the specific levy action (levy source, date levy will occur) and provide a name and contact information for the IRS employee whom the taxpayer can contact in order to otherwise resolve the tax debt.
- Amend IRC § 6330(a)(2)(C) to clarify that when the IRS mails a Notice of Right to a CDP Hearing prior to a proposed levy, it shall send that CDP notice by certified or registered mail but not with "return receipt requested."
- Amend IRC § 6330(d)(1) to consolidate judicial review of CDP in the United States Tax Court, and clarify the role and scope of Tax Court oversight of Appeals' continuing jurisdiction over the taxpayers' cases under IRC § 6330(d)(2). The scope of continuing judicial oversight should include review of IRS's authority to release levies under IRC § 6343(a) and to return levy proceeds under IRC § 6343(d).
- Codify the IRS Collection Appeals Program (CAP).
- Codify the IRS Audit Reconsideration Process.
- Amend IRC § 6330(c)(2)(B) to specifically include "audit reconsideration" as an alternative to be considered *within* the CDP hearing process.
- Amend IRC § 6330(d)(1) to provide that the Tax Court's authority to review the underlying liability shall be limited to a determination of whether the IRS abused its discretion in failing or refusing to consider the underlying liability in the CDP hearing.

[11] The example was taken from *Fowler v. Commissioner*, where the Tax Court held that the IRS had abused its discretion in rejecting the offer in compromise under similar facts. *Fowler v. Comm'r*, T.C. Memo. 2004-163.

PRESENT LAW AND ADMINISTRATIVE PROVISIONS

We briefly describe below existing CDP provisions and compare them to administrative provisions applicable to:

- Certain administrative procedures available outside of CDP for taxpayers in the collection process who want to contest disputed deficiency assessments (*i.e.*, the Audit Reconsideration Process); and
- Administrative procedures for taxpayers seeking relief from certain IRS collection actions who have either exhausted or failed to exercise their CDP rights (*i.e.*, Collection Appeals Program).

Notice of Federal Tax Lien

Prior to the IRS Restructuring and Reform Act of 1998 (RRA 98), the IRS was not required to issue a notice to the taxpayer when it filed a Notice of Federal Tax Lien (NFTL). IRC § 6320(a)(1) now requires the IRS to provide notice to the taxpayer each time it files a NFTL.

Notice of Intent to Levy

The IRS is required to send taxpayers a notice of its intent to levy prior to taking levy action.[12] The Notice of Intent to Levy must be provided to taxpayers at least 30 days before the date of the proposed levy.[13] Unlike the Notice of Federal Tax Lien, the IRS is only required to issue one Notice of Intent to Levy with respect to any particular tax debt.

Collection Due Process

CDP hearings provide taxpayers an opportunity for an independent review of a Notice of Federal Tax Lien[14] filed by the IRS or a proposed IRS levy action.[15] CDP provisions can be divided into five components:

- Notice of Right to Hearing;
- Hearing and Determination;
- Stay on levy actions;
- Judicial Review; and
- Continuing Appeals Jurisdiction.

[12] IRC § 6331(d).

[13] IRC § 6331(d)(2). The Notice of Intent to Levy can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail to the taxpayer's last known address.

[14] IRC § 6320.

[15] IRC § 6330.

Notice of Right to Hearing

The IRS must notify the taxpayer of the right to a CDP hearing after the IRS files its first Notice of Federal Tax Lien with respect to a particular tax debt.[16] The CDP hearing notice must be provided to the taxpayer not more than five days after the filing of the NFTL and must inform the taxpayer of his or her right to request a CDP hearing with the 30-day period that begins on the expiration of the fifth day after the filing of the NFTL.[17]

In the case of a levy, the CDP hearing notice must be provided to the taxpayer not less than 30 days before the first levy, and must inform the taxpayer of his or her right to request a hearing 30 days from the date that the notice is sent.[18] Issuance of the Notice of Intent to Levy and Your Right to Hearing does not signify that the IRS has determined which specific property it will levy.

Hearing and Determination

Taxpayers are entitled to one CDP hearing with respect to the first Notice of Federal Tax Lien (NFTL) and one CDP hearing for the first proposed levy action.[19] The CDP hearing process allows a pause in the collection process so that the taxpayer can raise issues germane to the collection of the tax, including:

- Appropriateness of collection actions;[20]
- Collection alternatives such as installment agreement, offer in compromise, posting a bond or substitution of other assets;[21]
- Appropriate spousal defenses;[22] 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.[23]

A taxpayer may not reintroduce an issue that was raised and considered at a prior administrative or judicial hearing if the individual participated meaningfully in the prior

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16 IRC 6320(a) and 6320(b)(2).

17 IRC § 6320(a)(2). The Notice of Federal Tax Lien can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail to the taxpayer's last known address. IRC § 6320(a)(3)(B). *See* National Taxpayer Advocate 2004 Annual Report to Congress 463-464 for a discussion of legislative recommendation to change date from which the 30 day period begins to run.

18 IRC § 6330(a)(2). The CDP hearing notice can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or sent by certified or registered mail (return receipt requested) to the taxpayer's last known address.

19 Treas. Reg. §§ 301.6320-(b)(1) and 301.6330-(b)(1). If the IRS sends the Notice of Federal Tax Lien and the Notice of Intent to Levy together, the IRS can hold a single CDP hearing rather than have two separate hearings. IRC § 6330(b)(4).

20 IRC §§ 6330(c)(2)(A)(ii) and 6320(c).

21 IRC §§ 6330(c)(2)(A)(iii) and 6320(c).

22 IRC §§ 6330(c)(2)(A)(i) and 6320(c).

23 IRC §§ 6330(c)(2)(B) and 6320(c).

hearing or proceeding.[24]

Under both lien and levy procedures, the taxpayer must return a signed, written request for a CDP hearing within 30 days of the date of the lien filing or the date of the notice, respectively.[25] Taxpayers who request a CDP hearing after the 30 day period expires will receive an "equivalent hearing," which is the same as a CDP hearing except there is no judicial review of an equivalent hearing.[26] Proposed revisions to the CDP regulations require the taxpayer to put the reasons for the CDP hearing in writing (preferably using Form 12153), and the failure to provide the basis for hearing may result in a denial of a face-to-face hearing.[27] Proposed revisions also eliminate the availability for equivalent hearings if the taxpayer does not make a request for a hearing within one year from the date of issuance of the CDP Notice.[28]

Collection Due Process hearings are informal. The Office of Appeals presumptively establishes telephonic CDP hearings, and it is incumbent on the taxpayer to request a face-to-face hearing.[29] Courts have determined that, depending on the circumstances, a CDP hearing need not be face-to-face with the Appeals officer,[30] but instead can take place by telephone,[31] or by an exchange of correspondence.[32] The hearing is to be held by an impartial officer from the Appeals function of the IRS.[33] In addition to addressing any issues described above that the taxpayer raises, the Appeals officer must obtain verification that the requirements of all laws and procedures have been satisfied for the IRS to proceed with collection activity.[34] Finally, and perhaps most importantly, in making its determination, Appeals must weigh the issues raised by the taxpayer and

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[24] IRC §§ 6330(c)(4) and 6320(c).

[25] IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B).

[26] Treas. Reg. § 301.6330-(1)(i).

[27] Prop. Treas. Reg. § 301.6320-1 and Prop. Treas. Reg. § 301.6330-1. Taxpayers will be given an opportunity to cure a failure to provide a basis for the CDP hearing. At least one professional group has expressed concerns about these provisions, including the language in the proposed regulation about face-to-face hearings. *See* American Bar Association Section of Taxation, Comments on Proposed Regulations Relating to Changes to Collection Due Process Procedures Under Sections 6320 and 6330 (Dec. 27, 2005).

[28] Prop. Treas. Reg. § 301.6320-1 and Prop. Treas. Reg. § 301.6330-1.

[29] Appeals Letter 3855. *See also* Treas. Reg. § 301.6320-1(d)(2) Q&A D6 and Treas. Reg. § 301.6330-1(d)(2) Q&A D6 regarding the informality of CDP hearings.

[30] For example, in *Casey v. Comm'r*, T.C. Memo. 2004-228, the Tax Court held that a face-to-face hearing was not required where taxpayer had a reasonable opportunity for a hearing, but changed addresses and failed to provide the IRS her new address. However, in *Cavanaugh v. U.S.*, 93 A.F.T.R.2d (RIA) 2004-1522 (D. N.J. 2004), where the facts were disputed as to whether the taxpayer knew that phone conversations constituted the taxpayer's CDP hearing, the court remanded the case for Appeals to provide a face-to-face hearing.

[31] In *Whiting v. Comm'r*, T.C. Memo. 2004-136, the Tax Court held that two phone conversations by the taxpayer's representative and the Appeals officer were sufficient to constitute a CDP hearing in the absence of testimony regarding the content of the phone conversations.

[32] Treas. Regs. §§ 301.6320-1(d)(2), Q&A-D6 and 301.6330-1(d)(2), Q&A-D6.

[33] IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1) and 6330(b)(3).

[34] IRC § 6330(c)(1).

determine whether the proposed levy action balances the need for efficient collection of taxes with the legitimate concern of the taxpayer that any collection action be no more intrusive than necessary.[35]

Stay on Collection

The IRS must suspend levy action throughout the CDP hearing process, unless it determines that the collection of the tax is in jeopardy.[36] Collection by levy is also suspended throughout any judicial review of Appeals' determination, unless the IRS can demonstrate to the court good cause to resume levy action.[37]

Judicial Review

Within 30 days of the Appeals determination, the taxpayer may petition the United States Tax Court or, where appropriate, the U.S. district court for judicial review of Appeals' determination.[38] Where the validity of the tax liability is properly at issue in the CDP hearing, the amount of the tax liability will be reviewed by the appropriate court on a *de novo* basis.[39] Where the appropriateness of the collection action is at issue, the court will review the IRS's administrative determination for abuse of discretion.[40] Taxpayers can raise any issue on judicial review which is permitted to be raised at a CDP hearing provided that the issue is actually raised at the CDP hearing.[41] Thus, issues such as whether the IRS abused its discretion in rejecting a collection alternative are reviewable on appeal from a CDP hearing, whereas rejection of those same collection alternatives would not be reviewable by any court if submitted at any other stage in the collection process, including as part of the Collection Appeals Process (discussed below).

Continuing Appeals Jurisdiction

Internal Revenue Code section 6330(d)(2) provides that the Office of Appeals shall retain jurisdiction over any CDP determination made by that office. This continuing jurisdiction shall include subsequent hearings requested by the taxpayer to consider:

35 IRC § 6330(c)(3).

36 IRC § 6330(e)(1) provides the general rule for the suspension of collection by levy while IRC § 6330(f) provides that section 6330 does not apply if the IRS has determined that collection of the tax is in jeopardy.

37 IRC§ 6330(e)(1) and 6330(e)(2). In *Burke v. Comm'r*, 124 T.C. 189 (2005), the Tax Court granted the IRS's motion to levy while the case was on appeal since the taxpayer was espousing only frivolous arguments; *see also Howard v. Comm'r*, T.C. Memo. 2005-100, where the IRS moved for and obtained from the court an order allowing resumption in levy activity on the taxpayer due to the taxpayer's frivolous arguments made solely for the purpose of delaying collection.

38 IRC §§ 6330(d)(1) and 6320(c).

39 The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing the IRS's administrative CDP determinations. H.R. Rep. No.105-599 at 266 (Conf. Rep.).The term *de novo* means anew. *Black's Law Dictionary*, 447 (7th ed. 1999).

40 *Robinette v. Comm'r*, 123 T.C. 85 (2004), *appeal docketed*, No. 04-4081 (8th Cir. Dec. 16, 2004) (noting that *abuse of discretion* means an adjudicator's decision which is arbitrary, capricious, clearly unlawful or without a sound basis in law or fact).

41 Treas. Reg. § 301.6320-1(f)Q&A-F5; Treas. Reg. § 301.6330-1(f)Q&A-F5.

- Collection actions taken or proposed with respect to the CDP determination, and
- Any change in the taxpayer's circumstances that may affect such determination, but only after the taxpayer exhausts all administrative remedies.

Audit Reconsideration Process

Through the IRS's Audit Reconsideration Process, individual taxpayers[42] are able to:

- Seek reevaluation of the results of a prior audit when the taxpayer disagrees with the original determination by providing information that was not considered in the original examination; or
- Contest the Substitute for Return (SFR) determination made by the IRS by filing an amended return.[43]

This process allows taxpayers another opportunity to argue before the IRS Examination function that the assessed liability is incorrect.[44] Taxpayers can be referred to the IRS Examination function from Collection,[45] Appeals,[46] or the Taxpayer Advocate Service. If the taxpayer's request for relief is denied by the Examination function, the taxpayer can appeal the result to the Office of Appeals unless the taxpayer did not qualify for audit reconsideration, or failed to appear for the audit reconsideration appointment.[47]

Audit reconsideration differs from liability determinations in CDP hearings in three important respects. First, taxpayers in the audit reconsideration process are able to dispute the underlying liability without regard to whether the taxpayer actually received a notice of the audit or a Notice of Deficiency or otherwise had an opportunity to dispute the liability. In CDP hearings, taxpayers are prohibited from raising the underlying liability if they received a Notice of Deficiency or otherwise had an opportunity to dispute the liability.[48] Second, there is no judicial review from Appeals' review of the audit reconsideration. Third, audit reconsideration is not required by statute whereas CDP is

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42 Audit reconsideration is not available for taxpayers who file tax returns other than Form 1040, i.e. corporations or other entities. IRM § 4.13.3.1.1.

43 IRC § 6020(b) allows the IRS to file a return for a taxpayer when the taxpayer has failed to file a tax return.

44 IRM § 4.13.1.3 provides some reasons a taxpayer might request audit reconsideration, such as where the taxpayer:
- did not appear for the audit;
- moved and did not receive correspondence from the IRS;
- has new documentation to present;
- disagrees with an assessment from an audit and has additional information to present; or
- disagrees with an assessment created under the Substitute for Return authority under IRC § 6020(b).

45 IRM § 4.1.4.27.1.

46 IRM § 4.1.4.41.

47 IRM § 4.13.6.1(2).

48 IRC § 6330(c)(2)(B). Certain categories of taxpayers are excluded from audit reconsideration that are not excluded under CDP, such as taxpayers who only advance frivolous arguments. IRM § 4.1.4.27.1. Audit reconsideration also excludes taxpayers who file returns on forms other than Form 1040, are claiming inability to pay, raise issues related to address changes, seek proof of prior payment, request explanation of account balances, and make refund inquiries. IRM § 4.13.3.1.1; IRM § 4.13.3.1.2.

codified in Internal Revenue Code sections 6320 and 6330.

Collection Appeals Program (CAP)

The Collection Appeal Program (CAP) allows taxpayers to appeal specific collection actions or proposed actions to the Office of Appeals, namely:

- Filing or planned filing of a Notice of Federal Tax Lien;
- Levy action or proposed levy action; and
- Rejection of proposed installment agreement or termination of an existing installment agreement.[49]

CAP is distinct from CDP in a number of ways. CAP is the only means for taxpayers to appeal a Notice of Federal Tax Lien both *before or after* it is filed.[50] In contrast, CDP hearings occur *after* the lien is filed.[51] Under CAP, appeals of levy actions can also occur *before or after* the levy action occurs.[52] CDP hearings typically occur *before* levy unless the IRS determines that collection of the tax is in jeopardy or unless the asset levied upon is a state tax refund.[53] CAP is a much quicker appeal process than CDP, and its scope of review is much narrower than that of CDP. The Office of Appeals' goal is to complete CAP cases within five business days.[54] In contrast, the average cycle time for a CDP hearing – measured from the point when a taxpayer's request for a hearing is filed with the IRS until a CDP Notice of Determination is issued – is approximately 236 days.[55] However, Appeals officers in CAP proceedings are still required to assemble a record to support the determination.[56]

CAP also serves as the forum to hear taxpayer appeals of rejected or terminated installment agreements. Internal Revenue Code § 6159(e) requires that the IRS provide for administrative review of proposed terminations of existing installment agreements. Section 7122(d)(2) requires the IRS to establish procedures for taxpayers to appeal the rejections of proposed installment agreement to the Office of Appeals. The IRS implemented both of these provisions as part of the CAP program. Rejections of offers in compromise can also be appealed to Appeals and are worked under different procedures.[57] Thus, CAP can be narrower than CDP in that it cannot be used to appeal rejections of

49 IRM § 8.7.2.2.

50 IRM § 5.1.9.4.

51 IRC § 6320(a).

52 IRM § 5.1.9.4.

53 IRC § 6330(f).

54 IRM § 8.7.2.2.8.

55 Information provided by the Office of Appeals as of June 30, 2005.

56 IRM § 8.7.2.2.3 provides that:
> At a minimum, the appeals file should include: a. copies of the relevant levy, lien, seizure documents; b. Form 433A or B; c. Any other relevant documents, such as copies of deeds, mortgages, counsel opinions.

57 IRC § 7122(d); IRM 8.13.2.

offers-in-compromise or to raise other issues that can be appealed through separate procedures, such as Trust Fund Recovery Penalties, penalty appeals or jeopardy levies.[58]

Other Collection Relief Provisions

Release of Liens

Section 6325 requires that the IRS release a lien when: (1) the liability for the amount assessed (with interest) has been fully satisfied or has become legally unenforceable; or (2) a bond is furnished to the Service guaranteeing payment of the amount assessed (with interest) within the period of limitations on collection.[59] The release of a federal tax lien extinguishes the underlying assessment lien on the property.[60]

Subordination of Liens

The Service may also subordinate a lien if (1) an amount equal to the amount of the lien or interest to which the certificate subordinates the tax lien is paid, (2) the IRS believes that the amount realized will be increased by the subordination of the lien, or (3) if the lien was imposed by section 6324B (relating to additional estate tax), if the government will be adequately secured after such subordination.[61] The IRS has discretion in deciding whether to subordinate liens.[62]

Release of Levies and Return of Levy Proceeds

The Internal Revenue Service *may* release levies at any time and for any reason as a matter of administrative discretion. Internal Revenue Code section 6343(a), however, *mandates* that levies be released on the occurrence of certain events, such as where the taxpayer enters into an installment agreement or where the IRS determines that the levy is creating an economic hardship due to the financial condition of the taxpayer.[63] Pursuant to IRC section 6343(d), the IRS has authority to return levy proceeds in certain cases, including where the taxpayer has entered into an installment agreement with

58 IRM § 8.7.2.2.2.

59 IRC § 6325(a)(1) and (2).

60 IRC § 6325(f)(1)(A).

61 IRC § 6325(d). *See also*, Treas. Reg. § 301.6325-1(d).

62 Treas. Reg. § 301.6325-1(d).

63 IRC § 6343(a)(1) provides in part:

> (1) In general.–Under regulations prescribed by the Secretary, the Secretary shall release the levy upon all, or part of, the property or rights to property levied upon and shall promptly notify the person upon whom such levy was made (if any) that such levy has been released if–
> (A) the liability for which such levy was made is satisfied or becomes unenforceable by reason of lapse of time,
> (B) release of such levy will facilitate the collection of such liability,
> (C) the taxpayer has entered into an agreement under section 6159 to satisfy such liability by means of installment payments, unless such agreement provides otherwise,
> (D) the Secretary has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer, or
> (E) the fair market value of the property exceeds such liability and release of the levy on a part of such property could be made without hindering the collection of such liability.

the IRS or the return of the levy proceeds will be in the best interests of the taxpayer and the government.[64]

Elsewhere in this report we discuss the problem of untimely levy releases in the Automated Collection System and the problem of additional levies taking place after an agreement to enter into an installment agreement has occurred or after the IRS has determined that the levy is causing the taxpayer an economic hardship.[65] If these additional levies occur, taxpayers can seek return of levy proceeds by filing a claim for the return of the property within nine months of the date of the levy.[66] If the request is denied, the taxpayer can file an appeal. Generally, there is no judicial review available to the taxpayer if the IRS denies his or her request for return of property. If the IRS fails to return property in violation of the law, however, the taxpayer may file suit in district court for damages under IRC § 7433.[67]

REASONS FOR CHANGE

Collection Due Process hearings enhance tax administration by providing taxpayers with important protections against IRS overreaching and abuse of its discretion in its collection powers. The CDP program affords taxpayers, who are caught up in a collection process that is largely automated, an opportunity to raise facts and circumstances relevant to the collection of tax before an independent Appeals officer.

In those instances where the taxpayer believes that Appeals did not make a determination that is supported by the facts and the law, taxpayers have access to judicial review. Judicial review is an essential component of CDP rights because in some instances the IRS collection system demonstrates:

- Resistance to taking into consideration taxpayers' changed circumstances;[68]

[64] IRC § 6343(d)(2) grants the IRS the authority to return levied property where:
(2) the Secretary determines that–
(A) the levy on such property was premature or otherwise not in accordance with administrative procedures of the Secretary,
(B) the taxpayer has entered into an agreement under section 6159 to satisfy the tax liability for which the levy was imposed by means of installment payments, unless such agreement provides otherwise,
(C) the return of such property will facilitate the collection of the tax liability, or
(D) with the consent of the taxpayer or the National Taxpayer Advocate, the return of such property would be in the best interests of the taxpayer (as determined by the National Taxpayer Advocate) and the United States.

[65] *See* Most Serious Problem: *ACS Levy Releases, supra.*

[66] IRC § 6343(b) and (d).

[67] IRC § 7433 requires taxpayers to prove that an officer or employee of the IRS "recklessly or intentionally, or by reason of negligence" disregarded a provision of the Code or Treasury regulations to prove damages.

[68] In *Cavanaugh v. U.S.*, 93 A.F.T.R.2d (RIA) 1522 (D. N.J. 2004), the court held that it was an abuse of discretion for the IRS to refuse to consider the changed financial circumstances of a taxpayer whose inability to pay was diminished. The court rejected the IRS's policy-based argument that it would open the door to devious taxpayers who could take advantage of the system.

- Adherence to administrative procedures over the substance of account resolution;[69]
- The desire to obtain efficiencies of scale at the expense of providing taxpayers with a reasonable CDP hearing;[70] and
- Willingness to proceed with collection of a liability when it is uncertain or doubtful that the liability is validly owed.[71]

On the other hand, CDP fails to address the thousands of IRS collection determinations that taxpayers raise outside of the CDP process.[72] Some commentators note that CDP's biggest flaw is that it provides a static "picture frame" review for what is a dynamic "video" process.[73] In other words, the circumstances of taxpayers change throughout the tax collection process; CDP, however, provides Appeals and the courts with a single review of the taxpayer's circumstances.

IRS Experience with CDP

Since its enactment, the IRS Collection function and the Office of Appeals have struggled to handle CDP cases in a timely manner.[74] Yet, despite millions of CDP notices issued annually, taxpayers have not flooded the IRS with requests for CDP hearings, nor have they flooded the courts with CDP petitions. As Table 2.7.1 demonstrates, of the 2,276,684 CDP notices sent to taxpayers in FY 2004, only 1.24 percent of taxpayers requested CDP hearings.[75]

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[69] *Ramirez v. Comm'r*, T.C. Summ. Op. 2004-48 (holding it was an abuse of discretion for Appeals officer not to review offer in compromise when Appeals received the offer 8 days after the deadline and 3 days after the Appeals officer closed the case, but 4 days prior to the mailing of the Notice of Determination). *See also, Johnson v. Comm'r*, T.C. Summ. Op. 2005-47 (denying motion for summary judgment because petitioner's income for the years at issue was in dispute and raised a genuine issue of material fact. The Appeals officer had rejected collection alternatives raised by a homeless taxpayer who had not filed tax returns for 2001 and 2002, finding that although the taxpayer's income appeared to be below the level required for filing, payments on the mortgage during these years exceeded the amount of known income indicating possible self-employment income).

[70] *Parker v. Commissioner*, T.C. Memo. 2004-226 (holding that the taxpayer did not waive his right to a hearing at the nearest appeals office (New Orleans) when the taxpayer agreed to a telephone conference with Appeals in Jackson, Mississippi, 180 miles away).

[71] *Skrizowski v. Comm'r*, T.C. Memo. 2004-229 (holding it was an abuse of discretion to not fully investigate the offer in compromise before rejecting it and not basing rejection on taxpayer's income, assets and allowable expenses, and ability to pay. The court found that the taxpayer did not receive $5 million in business income reported on taxpayer's return when taxpayer was intoxicated when he submitted the delinquent return after allegedly being told by an IRS collections officer that he could go to jail if he did not file the return, and further noted that the Appeals officer did not believe the reported income was valid).

[72] Leslie Book, *The Collection Due Process Rights: A Misstep or a Step in the Right Direction?*, 41 Hous. L. Rev. 1145, 1148 (2004).

[73] Bryan T. Camp, *Replacing CDP*, 107 Tax Notes 1039 (May 23, 2005).

[74] *See* National Taxpayer Advocate 2002 Annual Report to Congress 110; *see also* National Taxpayer Advocate 2003 Annual Report to Congress 38.

[75] By way of comparison, in FY 2004 of the approximately 500,000 Notices of Deficiency issued, approximately 16,000 (or 3.2 percent) filed petitions with the Tax Court. Audit Information Management Systems (AIMS), Closed Case Database FY 2004.

TABLE 2.7.1, COLLECTION DUE PROCESS – FY 2004

Collection Due Process – FY 2004

IRC 6320 - Lien	NFTLs Filed	CDP Lien Requests*	% of CDP Requests
ACS	280,284	6,925	2.47%
CFf	257,539	2,612	1.01%
Total	537,823	9,537	1.77%
IRC 6330 - Levy	**CDP Levy Notices**	**CDP Levy Requests***	**% of CDP Requests**
ACS –	1,628,467	13,951	.86%
CFf	110,394	4,645	4.21%
Total	1,738,861	18,596	1.07%
Grand Total	**2,276,684**	**28,133**	**1.24%**

Timing of CDP Hearings

Taxpayers are provided the right to request a CDP hearing before the IRS takes its first levy action with respect to any tax (or after it files its first Notice of Federal Tax Lien, but still before its first levy action). If a taxpayer timely requests a CDP hearing, the IRS generally cannot take any levy action until the hearing is final, which can take years in the case of a taxpayer who seeks judicial review of the hearing determination.[76] This stay on levy action can lead to counterproductive and even improper behavior on the part of the IRS and on the part of taxpayers.

CDP hearings were enacted to provide taxpayers with a chance to resolve their tax collection problems at the earliest point in the collection process, by providing taxpayers with an opportunity to deal with all issues – liability, collection alternatives, spousal defenses – at one time. However, the collection stay's real and perceived effect on the ability of the IRS to collect has caused the IRS to try to accelerate the CDP process. For example, to improve collection cycle time, the IRS Collection Field function has changed its procedures to provide certain taxpayers with Notices of Intent to Levy and Right to Due Process Hearing *before* the taxpayer has shown that he or she will not work with the IRS to resolve the liability and when the IRS does not yet know whether it

[76] IRC § 6330(e)(1) provides a suspension of levy actions, along with the running of the 10 year statutory period for collecting tax. An exception exists when the IRS determines that the collection of tax is in jeopardy. IRC § 6330(f). Additionally, with a showing of good cause, the IRS can move to lift the suspension of collection activity while the case is on judicial review, provided the underlying liability is not at issue. IRC § 6330(e)(2).

will, in fact, levy.[77] In fact, when the IRS tested its Initial Contact Initiative for business taxpayers in the IRS's Collection Field function, the percentage of taxpayers exercising CDP rights decreased from 4.1 percent to 0.12 percent.[78]

The IRS may argue that because these taxpayer cases are in the Collection Field function, the IRS will most certainly take levy action against these taxpayers. This argument is unpersuasive, since it is precisely this type of generalized assumption of taxpayer behavior – as opposed to a facts and circumstances analysis – that CDP was designed to avoid. Although many taxpayers in the Collection Field function may indeed have some levy action taken against them, CDP exists so that taxpayers who are trying to work things out with the IRS have a one-time opportunity to place all their "collection cards" on the table.

The IRS is also currently planning to reduce the number of notices sent to taxpayers in the "notice stream" portion of the collection cycle prior to issuing a Notice of Intent to Levy and Right to Collection Due Process Hearing.[79] Business taxpayers will receive the CDP notice in the second collection notice, and it is proposed that individual taxpayers will receive the CDP notice in the fourth collection notice. While these changes enable the IRS to reduce collection cycle time, this approach will harm taxpayers, particularly individual taxpayers, by increasing the likelihood that taxpayers will *not* actually receive the CDP hearing notice. This is so because the notice will be sent before the IRS checks the taxpayer's "last known address" against commercial databases and verifies whether there is a more current address for the taxpayer.[80]

On the other hand, in at least 35 of the 209 CDP opinions (or approximately 17 percent) that were reviewed for this year's most litigated issue, Collection Due Process, courts deemed arguments made by taxpayers frivolous and made solely for the purpose

[77] In 2005, the IRS Collection Field function established an initiative whereby it would issue delinquent taxpayers the *Notice of Intent to Levy and Your Right to a Hearing* (which triggers the 30-day period for the taxpayer to request a CDP hearing) on initial contact with taxpayers. The National Taxpayer Advocate objected to the initiative for several reasons, including that taxpayers who were just beginning to work cooperatively with the IRS were handed a notice informing them that their CDP rights would expire within 30 days, thereby forcing the taxpayers to decide between electing CDP rights prematurely or foregoing these rights altogether. The IRS agreed to limit the initiative to business taxpayers who habitually fail to remit payroll taxes as well as those business taxpayers who have delinquent individual accounts. *See* National Taxpayer Advocate's Report to Congress: Fiscal Year 2006 Objectives 12.

[78] Small Business/Self-Employed Division, *Initial Contact Study of BMF Taxpayers* (2005).

[79] Generally, individual taxpayers receive four collection notices prior to the Notice of Intent to Levy and Right to Due Process Hearing. Business taxpayers receive two collection notices prior to the Notice of Intent to Levy and Right to Due Process Hearing. See IRM § 5.19.1 and Exhibit 5.19.1-2(1)(n).

[80] In an IRS study of the effect of issuing CDP notices in the Collection Field function at the time of first contact with the taxpayer, business taxpayers only requested CDP hearings 0.12 percent of the time. This figure differs significantly from the 4.21 percent response rate in FY 2004 for the Collection Field function. Thus, from the taxpayers' perspective, the early issuance results in a virtual elimination of CDP rights.

of delay, imposing at least $160,100 in penalties against CDP litigants in the aggregate.[81] The courts are clearly addressing this abuse of process. Moreover, the IRS, in proposed regulations, recently suggested procedures for dealing with taxpayers who seek to raise *only* frivolous issues in CDP hearings before the Office of Appeals.[82] Over time, procedures such as these will help to protect the integrity of the CDP process.[83]

Judicial Oversight of Later Collection Actions

One of the major flaws in the CDP hearing process is that it provides no protection for taxpayers who have failed to request a CDP hearing, and thus cannot seek judicial oversight of subsequent IRS levy actions with respect to a particular tax debt. The availability of the Collection Appeals Program (CAP) provides administrative oversight of some lien and levy action. However, the CAP process with respect to liens and levies exists as an exercise of the IRS's administrative discretion and could be curtailed according to that discretion. Moreover, CAP determinations are not subject to judicial review.

Review of Underlying Liability

In the 2004 Annual Report to Congress we set forth our reasons for proposing that *de novo* judicial review of the underlying liability in the context of CDP hearings be replaced with judicial review of whether the Office of Appeals abused its discretion in refusing to consider or failing to properly consider the underlying liability in CDP hearings.[84] Under current procedures, if the taxpayer has actually received the Notice of Deficiency or otherwise had an opportunity to dispute the tax liability, the underlying liability is not within the purview of the CDP hearing, and it is left to the Appeals Officer's discretion whether to consider the underlying liability after he or she has issued the Notice of Determination.[85] This approach, while defensible under the statute because this type of liability determination is not subject to judicial review, is backward,

[81] IRC § 6673(a) allows the Tax Court to impose up to $25,000 in fines against a taxpayer who makes frivolous arguments or engages in litigation solely for the purpose of delay. The percentage of frivolous CDP cases (i.e. where the court deemed the taxpayer's arguments frivolous) *reviewed* is down from 23 percent in 2004 and 52 percent in 2003. See National Taxpayer Advocate 2004 Annual Report to Congress 510.

[82] Prop. Treas. Reg. § 301.6320-1 and Prop. Treas. Reg. § 301.6330-1.

[83] *But see* American Bar Association Comments on Proposed Regulations Relating to Changes to Collection Due Process Procedures Under Section 6230 and 6330 (Dec. 27, 2005):

> To reduce the risk that taxpayers who could raise nonfrivolous issues are inadvertently classified as advancing solely frivolous positions and denied a face-to-face conference, we suggest that the IRS continue to publish on its website and to begin including in the instructions to Form 12153 the positions it deems frivolous.

The National Taxpayer Advocate agrees with this recommendation.

[84] *See* National Taxpayer Advocate 2004 Annual Report to Congress 481 - 483.

[85] Internal Revenue Service procedures do not provide clear guidance to Appeals officers on how to exercise their discretion to review the validity of the underlying liability when taxpayers are procedurally barred from raising the issue in CDP hearings. While the procedures require that Appeals Officers should make reference in the Notice of Determination that consideration of the liability issue was addressed under separate consideration from the CDP hearing (see IRM § 8.7.2.3.13(5)(f)), tax practitioners inform us that in practice the decision of whether to exercise such discretion is routinely made after the Notice of Determination is issued.

in that the IRS *first* determines whether it should take levy action and only *later* determines whether there is any debt to be collected at all.

EXPLANATION OF RECOMMENDATIONS

The Collection Due Process provisions require Congress and the IRS to carefully balance the taxpayers' interest in having collection action be as least intrusive as possible while protecting the government's and all taxpayers' interest in ensuring that all taxpayers pay their fair share of tax. In making these legislative recommendations, the National Taxpayer Advocate has carefully considered these concerns.

We propose that the Notice of Right to a Collection Due Process Hearing under IRC § 6330 be issued at the time the IRS takes its first levy action, rather than at least 30 days before it plans to take levy action. Specifically, we propose separating the Notice of Intent to Levy under IRC § 6331 and the Notice of Right to CDP Hearing under IRC § 6330. Under this proposal, the IRC § 6331 notice will serve to inform the taxpayer that the IRS is now poised to take levy action and advise the taxpayer of the various rights he or she has with respect to levies and liens.[86] On the other hand, the IRC § 6330 notice will clearly advise the taxpayer that the IRS has now determined that it will take a specific (first) levy action and the taxpayer now has 30 days to request a CDP hearing.

This change will force the IRS to give clear and distinct notice of the right to a CDP Hearing when it actually intends to take a specific action. It will prevent the IRS from issuing the CDP Hearing notice so far in advance of a specific proposed levy action it intends to take as to render the right to a hearing meaningless. Moreover, it will prevent the IRS from issuing this notice either before it has determined that the taxpayer will not work with the IRS in resolving the debt or before it has taken steps to ensure that the CDP notice is being sent to the most current address for the taxpayer. This change will also enable the IRS to take the specific levy action immediately after the expiration of the 30-day period. Thus, taxpayers will be on notice that the IRS is poised to take a specific action (*e.g.*, levying on a specific bank account or garnishing wages), and the IRS, having issued the CDP hearing notice concurrent with the notice to specifically identify the source of funds, will be poised to take action in the event the taxpayer does not request a CDP hearing.

We further propose that where the CDP Notice under IRC § 6330(a)(1) is mailed, the IRS must use certified or registered mail, but it should no longer be required to send such notices by return receipt requested. This change will save taxpayers millions of dollars in postage each year without impairing rights to receive notice, and bring CDP procedures in conformity with mailing requirements for the CDP Lien Notice under IRC § 6320.

[86] IRC 6331(d)(4) provides a list of the information to be provided with this notice.

Clearly, taxpayers need effective judicial oversight of IRS lien and levy actions both at the outset of collection case and during its progression. The IRS, however, needs to be able to pursue lien and levy action without being stopped for months or even years every time it initiates such action. The National Taxpayer Advocate believes that these two needs can be reconciled by clarifying in the Code the role of judicial oversight of Appeals' ongoing jurisdiction in CDP cases. Thus, for a subset of U.S. taxpayers, the courts will have the authority to review the entirety of the collection life cycle. In turn, where the courts find that the IRS has abused its discretion, all taxpayers will benefit from the changes in procedures or additional training that result from such decisions. Moreover, by clarifying that the scope of the courts' continuing jurisdiction includes the IRS's authority to release levies and return levy proceeds, Congress will improve the oversight of these important provisions.

Moreover, by consolidating CDP jurisdiction in the United States Tax Court, Congress will eliminate confusion and delay as a result of multiple cases dealing with one taxpayer (and one set of financial assets and income sources available for collection) and two types of tax. Consolidation will also place oversight of IRS lien and levy action in a court that is known for its taxpayer-friendly procedures.

As a matter of fairness and due process of law, the government should only collect the correct amount of tax. Thus, the audit reconsideration process, which currently exists by administrative grace, should be codified in order to prevent injustice. Further, the CDP statute should be amended to clarify that the Appeals Officer conducting a CDP hearing shall consider the underlying liability not only when the taxpayer has not received the Statutory Notice of Deficiency or not had an opportunity to otherwise dispute the tax, but also when the issue meets the criteria for audit reconsideration. The Appeals Officer's findings should be part of the Notice of Determination and the administrative record. The courts, however, will only review the issue of whether the IRS abused its discretion in failing to consider the underlying liability properly or at all.

Finally, to ensure that taxpayers continue to have the right to go to the Office of Appeals for administrative review of IRS collection actions outside of Collection Due Process Hearings, Congress should codify the Collection Appeals Program. We anticipate that the process of codifying both CAP and Audit Reconsideration will provide Congress with an opportunity to hear from stakeholders and the IRS about concern with these programs, how IRS Collection and Examination practice can be improved, and what is the appropriate role of judicial oversight for all taxpayers in the IRS collection process.

ADDITIONAL LEGISLATIVE RECOMMENDATION: DIRECT DEPOSIT OF INCOME TAX REFUNDS

PROBLEM

Under present law, there are no procedures in place for the IRS, the government's Financial Management Service (FMS), and financial institutions to address inadvertent errors by taxpayers relating to direct deposits of tax refund checks.[1] There are also no provisions to allow the IRS to take money out of an incorrect account or receive confidential information about the owner of an incorrect account from the financial institution. This situation leaves the IRS with access only to the information the incorrect account owner voluntarily provides to the IRS after the bank contacts the customer on behalf of the IRS. Thus, any dispute over the accuracy of a direct deposit refund must currently be resolved between the taxpayer and the financial institution itself, with little assistance from the IRS. While financial institutions can correct a mistake that they made, they do not always take corrective action when the taxpayer himself made the mistake. Without a process in place for handling these cases, there is no remedy for the taxpayer.

EXAMPLE

Jane Jones prepared her 2003 tax return herself and was entitled to a $2,500 refund from the IRS. On February 15, 2004, Jane filed her return electronically, providing her bank account and routing numbers so she could receive her refund quickly through IRS direct deposit. On March 15, 2004, Jane checked her bank account and realized she had not yet received her refund from the IRS. Jane used the "Where's My Refund?" tool on the IRS website (www.irs.gov) and learned her refund was deposited in her account on March 1, 2004. Jane checked the printout of her 2003 return and realized she had made a mistake – the account number she provided the IRS was off by one number. In this case, the mistake was due entirely to Jane's error. Although this mistake was a minor one, the IRS did exactly as instructed with Jane's refund, and as a result, her refund was deposited in someone else's account.

RECOMMENDATION

Amend the Internal Revenue Code to create a process through which the IRS and financial institutions work together to identify the incorrect recipient of a direct deposit refund and request the return of the improperly deposited funds. The Right to Financial Privacy Act, 12 U.S.C. § 3401 *et seq.*, prohibits financial institutions from releasing financial records except under limited circumstances.[2] 12 U.S.C. § 3413(c) provides an exception to the financial disclosure rules, allowing for the sharing of financial records in

[1] For a detailed discussion of problems arising out of misdirected direct deposit tax refunds, *see* Most Serious Problem, *Direct Deposit of Income Tax Refunds, supra.*

[2] Under 12 U.S.C. § 3402, financial institutions may not release information to government authorities without customer authorization, administrative subpoena or summons, search warrant, judicial subpoena, or a formal written request which meets the requirements of 12 U.S.C. § 3408.

accordance with procedures in the Internal Revenue Code. The Internal Revenue Code should be amended to establish a formal procedure through which the IRS can receive limited information about an account holder who receives a misdirected direct deposit refund. The information provided to the IRS would be limited to the account holder's name, social security number, and necessary contact information to allow the IRS to contact the account holder and attempt to recover the misdirected funds.

The National Taxpayer Advocate further recommends that Congress amend Title 31, Money and Finance, of the current U.S. Code to treat misdirected direct deposit refunds in the same manner as checks.[3] 31 U.S.C. § 3343 provides a fund for the replacement of checks that are lost, stolen, destroyed, or defaced. There is currently no similar provision available providing a fund for the replacement of direct deposit refunds misdirected as a result of fraud.

[3] This recommendation was made by the joint Wage and Investment, Taxpayer Advocate Service Direct Deposit Task Force. For a discussion of the administrative recommendations the task force proposed, *see* Most Serious Problem: Direct Deposit of Income Tax Refunds, *supra*.

ADDITIONAL LEGISLATIVE RECOMMENDATION: SOCIAL SECURITY LEVIES

PROBLEM

The Code exempts from IRS levy certain pension and annuity payments (including payments under the Railroad Retirement Act), but does not exempt from levy retirement, survivors, and disability insurance payments made under the Social Security Act.[1] As discussed in the Most Serious Problem entitled "Levies on Social Security Payments," levies by the IRS on Social Security benefits can cause particularly severe hardships for low income taxpayers who rely on these payments as their primary or sole source of income. By definition, recipients of Social Security benefits are elderly or disabled workers, or the surviving dependents of deceased workers.

Congress recognized that taxpayers need a certain amount of income to live on and established an exemption from levies.[2] This exemption amount is indexed for inflation and varies based on the taxpayer's filing status and family size. However, this exemption does not apply to levies generated by the automated Federal Payment Levy Program (FPLP).[3] As a result, the IRS may levy on the first dollar of Social Security benefits via the FPLP, regardless of the amount of monthly benefits the taxpayer is receiving.

For nontax debts, Congress provided a mechanism to safeguard against excessive collection action against those who are suffering from economic hardship and cannot afford to pay. The Debt Collection Improvement Act of 1996,[4] among other things, exempted the first $9,000 per year (which results in an exemption of $750 per month) of Social Security and certain other federal benefits from administrative offset for the collection of nontax debts owed to federal agencies.

The IRS has been unable to develop an effective mechanism to identify and exclude taxpayers who might experience significant hardship if levied under the FPLP. The absence of any statutory exemption, combined with the IRS' inability to devise an effective screen administratively, increases the likelihood of FPLP levies being applied against low income Social Security recipients and causing significant economic harm.

1 *See* IRC § 6334(a)(6). The SSA provides two general categories of benefits – Supplemental Security Income (SSI) and Old-Age, Survivors, and Disability Insurance (OASDI). The SSI program provides needs-based (means-tested) benefits to individuals who are age 65 or older, blind, or disabled. The OASDI program protects against the loss of earnings due to retirement, death, or disability. The exemption in 6334(a)(11)(A) applies to SSI only.

2 IRC § 6334(a)(9) provides a minimum exemption for wages, salary, and other income, as determined under IRC § 6334(d). This exemption amount is published in Publication 1494.

3 *See* IRC §§ 6334(f); 6331(h).

4 Pub. L. No. 104-134 (1996); 31 U.S.C. § 3701 *et seq.*

EXAMPLE

Jane Doe is a retired widow whose sole source of income consists of a $600 monthly benefit from Social Security. Ms. Doe owns a home and a car, but no other assets of value. Three years ago, the IRS assessed $5,000 against a joint return filed by Ms. Doe and her deceased husband, and now seeks to recover this amount via levy.

Because Ms. Doe earns less than the exemption amount under IRC 6334(a)(9) ($683.33 per month for single taxpayers with one exemption claimed[5]), the IRS is prohibited from applying a manual levy. However, because the exemption amount does not apply to FPLP levies, the IRS may levy 15 percent ($90) of Ms. Doe's monthly Social Security benefit.

RECOMMENDATION

The National Taxpayer Advocate recommends that Congress exempt Social Security payments altogether from IRS levy by amending IRC 6334(a)(6) to include payments under the Social Security Act . This proposal would treat Social Security payments on par with payments made under the Railroad Retirement Act, which are exempt from IRS levy under current law.

In the alternative, the National Taxpayer Advocate recommends that Congress extend the automatic exemption amount to FPLP levies on Social Security payments by amending IRC § 6331(h)(1) and IRC § 6334(f) to state that the exemption in IRC § 6334(a)(9) will apply whenever the "specified payment" being levied is made under the authority of the Social Security Act. This change would provide for a minimum exemption amount that would apply automatically for all levies of Social Security payments, regardless of the type of levy the IRS chooses to issue. This proposal would also make the automated levy process more consistent with the automated offset process applicable to nontax debts.

5 *See* IRS Pub. 1494, *Table for Figuring Amount Exempt from Levy on Wages, Salary, and Other Income* (2005).

ADDITIONAL LEGISLATIVE RECOMMENDATION: DEBT COLLECTION TECHNIQUES ON EITC BENEFITS BY REFUND ANTICIPATION LOAN INDUSTRY

PROBLEM

Financial institutions or banks that issue refund anticipation loans (RALs) are currently permitted to offset, or set off, RAL proceeds to satisfy outstanding delinquencies owed on RALs previously issued by either the contracting bank or a third party bank. Although the loan documents disclose this debt offset collection practice, it is unclear whether RAL customers fully comprehend its ramifications. Further, the practice allows banks to effectively seize earned income tax credit (EITC) benefits and transfer the funds to themselves or third party banks to satisfy delinquencies on previously issued RALs.

Federal law prohibits banks from exercising their right to set off on Social Security benefits.[1] IRC § 32 contains no analogous provision to prevent banks from offsetting EITC benefits to pay off delinquencies owed by RAL customers, despite the fact that the EITC is the largest federal means-tested anti-poverty program.[2] At the very least, the law should prohibit banks from transferring to a third party bank any portion of a federal tax refund representing the EITC.

EXAMPLE

In February 2006, Taxpayer visits a commercial tax return preparer (Preparer) to prepare his 2005 federal income tax return. To pay off some delinquent utility bills, Taxpayer decides to take out a refund anticipation loan (RAL) with the financial institution associated with Preparer (Bank). Taxpayer is due a refund of $3000, which includes the EITC. After all of the loan documents and disclosure forms have been signed and Bank has approved the loan, Taxpayer receives only $1,200 of the $3,000 RAL he expected. Under a provision of the signed RAL agreement, Bank transmitted the remaining $1,800 to a third party financial institution that issued a RAL to Taxpayer during 2005 for his tax year 2004 income tax refund. Taxpayer still owed $1,800 on the previous RAL because the IRS did not release the entire expected refund for 2004.

[1] 42 U.S.C. § 407(a) provides:

> The right of any person to any future payment under this subchapter shall not be transferable or assignable, at law or in equity, and none of the moneys paid or payable or rights existing under this subchapter shall be subject to execution, levy, attachment, garnishment, or other legal process, or to the operation of any bankruptcy or insolvency law.

See, e.g., Hambrick v. First Security Bank, 336 F. Supp.2d 890 (E.D.Ark. 2004.); *Tom v. First American Credit Union,* 151 F.3d 1289 (10th Cir. 1998).

[2] In tax year 2003, 21.4 million taxpayers received credits totaling over $38 billion. Earned Income Tax Credit Fact Sheet: Tax Years 2001, 2002 and 2003 Returns (July 19, 2005).

RECOMMENDATION

Amend IRC § 32 to include language similar to that contained in the Social Security Act.[3] This legislative language would protect the EITC portion of RAL proceeds from being transferred pursuant to the banks' debt offset or cross-collection practices.[4]

3 *See* 42 U.S. C. § 407(a).

4 An example of language protecting EITC benefits from offset can be found in the Taxpayer Abuse Prevention Act, S.324, 109th Cong. § 2 (Feb 9, 2005), as follows:

> Section 32 of the Internal Revenue Code of 1986 (relating to earned income tax credit) is amended by adding at the end the following new subsection:
> '(n) Prevention of Diversion of Credit Benefits- The right of any individual to any future payment of the credit under this section shall not be transferable or assignable, at law or in equity, and such right or any moneys paid or payable under this section shall not be subject to any execution, levy, attachment, garnishment, offset, or other legal process except for any outstanding Federal obligation. Any waiver of the protections of this subsection shall be deemed null, void, and of no effect.'

Section 3 of S.324 includes language prohibiting the general cross-collection practice by banks issuing RALs or refund anticipation checks (RACS).

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MOST LITIGATED ISSUES: INTRODUCTION

Internal Revenue Code § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify the ten tax issues most often litigated in the federal courts, classified by 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. The recommendations included in this analysis could minimize some of the litigation covered in this section.[1]

Taxpayer Advocate Service (TAS) analysts utilized commercial legal research databases to identify the ten most litigated issues (Most Litigated Issues) in federal courts during the period of June 1, 2004 through May 31, 2005.[2] For purposes of the Most Litigated Issues section of the report, the term "litigated" refers to cases in which the court issued an opinion.[3] The ten Most Litigated Issues identified for this year are:

- Collection Due Process hearings, under IRC §§ 6320 and 6330;
- Gross income, under IRC § 61 and related Code sections;
- Failure to file penalty, under IRC § 6651(a)(1);
- Trade or business expenses;
- Frivolous issues penalty, under IRC § 6673;
- Negligence penalty, under IRC § 6662(b)(1);
- Family status issues, under IRC §§ 2, 21, 24, 32 and 151;
- Relief from joint and several liability for spouses, under IRC § 6015;
- Summons enforcement, under IRC § 7604; and
- Trust Fund Recovery Penalty, under IRC § 6672.

The top ten litigated issues are substantially similar to those identified in 2004,[4] with some important exceptions. For the first time, summons enforcement is a Most Litigated Issue, which may be due in part to the IRS's increased emphasis on enforcement.[5] While the

1 For example, Collection Due Process (CDP) is again the number one most litigated issue this year. The National Taxpayer Advocate is making a legislative recommendation to reform CDP legislation, designed to increase the availability of review for some taxpayers while reducing the incentive to appeal solely for the purpose of delaying collections. *See* Key Legislative Recommendation: *Restructuring and Reform of Collection Due Process Provisions*, *supra.*

2 Federal tax cases are tried in the United States Tax Court, the United States district courts, the United States Court of Federal Claims, the United States bankruptcy courts, United States Courts of Appeals and the United States Supreme Court.

3 We recognize that many cases are resolved prior to the court issuing an opinion. Some taxpayers are able to reach settlement with the IRS before trial while other taxpayers' cases are dismissed for a variety of reasons, including lack of jurisdiction and lack of prosecution. In addition, courts can also issue less formal "bench opinions" which are not published or precedential. For example, bench opinions are issued by the United States Tax Court pursuant to Tax Court Rule 152, wherein Tax Court Trial Judges or Special Trial Judges read oral findings of fact or opinion into the trial transcript. We received copies of some bench opinions for Collection Due Process cases, this year's most litigated issue.

4 *See* National Taxpayer Advocate 2004 Annual Report to Congress 495.

5 Beginning in 2002, the IRS identified the increased use of summonses as a part of the overall shift in audit priorities toward abusive schemes and promoter investigations. IRS News Release, *IRS Sets New Priorities*, September 2002.

other issues remain substantially the same, there was a reordering of the top ten issues caused by a decrease in litigation involving family status issues[6] and an increase in litigation involving the failure-to-file penalty, the negligence penalty, and the frivolous issues penalty.[7]

Once the ten issues were identified, TAS personnel provided analysis for each issue that includes four sections: a summary of the findings, a description of the present law, analysis of the litigated cases and a conclusion. We have listed each of the cases litigated, by issue, in Appendix 3 of this report and have categorized the cases by type of taxpayer. The case listings for each issue identify the specific citation of the case, the main issue(s), whether the taxpayer was represented at trial or argued the case *pro se*, and the decision of the court. We classify the "opinion" of the court as a decision for the taxpayer, the IRS, or as a split decision. For purposes of this analysis, when identifying the decision of the court we only considered the issue analyzed, and a split decision was defined as a partial allowance of the specific issue litigated.

AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

Taxpayers generally have access to four different tribunals in which to initially litigate a tax matter – the United States Tax Court, United States district courts, the United States Court of Federal Claims, the United States bankruptcy courts. With limited exceptions, taxpayers have an automatic right of appeal from decisions of the trial court.[8]

The United States Tax Court is generally a "prepayment" forum in that taxpayers have access to the Tax Court without having to pay the disputed tax in advance. The Tax Court has jurisdiction over a variety of issues, to include deficiencies, certain declaratory judgment actions, collection due process, and relief from joint and several liability.[9]

The federal district courts and the Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,[10] and (2) the taxpayer has filed an administrative claim for refund.[11] The federal district courts are the only forums in which a taxpayer can receive a jury trial. Bankruptcy courts can adjudicate tax matters that were not previously adjudicated before the initiation of a bankruptcy case.[12]

6 There was a 60 percent decrease in Family Status related issues down from 72 litigated in 2004 to 45 litigated in 2005.

7 There was also a 60 percent increase in failure-to-file penalty litigation and a 91 percent increase in litigation involving application of the frivolous issues penalty.

8 *See* IRC § 7482 (providing that the United States Courts of Appeals have jurisdiction to review the decisions of the Tax Court). There are exceptions to this general rule. For example, IRC § 7463 provides special procedures for small Tax Court cases (where the amount of the deficiency or claimed overpayment totals $50,000 or less) from which appellate review is not available. *See also* 28 U.S.C. § 1294 (appeals from district court are to the appropriate Court of Appeals); 28 U.S.C. § 1295 (appeals from Court of Federal Claims are heard in the Federal Circuit Court).

9 IRC §§ 6214, 7476-7479, 6330, and 6015.

10 28 U.S.C. § 1346(a)(1). *See Flora v. United States*, 362 U.S. 145 (1960).

11 IRC § 7422(a).

12 *See* 11 U.S.C.A. §§ 505(a)(1) and (a)(2)(A).

ANALYSIS OF *PRO SE* LITIGATION

As in the previous two years our analysis indicated that many taxpayers represented themselves before the courts, *pro se*.[13] The following table (Table 3.I-01) lists the most litigated tax issues for the period June 1, 2004, through May 31, 2005, and identifies the number of cases in which taxpayers represented themselves before the court.

TABLE 3.I-01, *PRO SE* CASES BY ISSUE

Most Litigated Issue	Total Number of Litigated Cases Reviewed	*Pro Se* Litigation	Percentage of *Pro Se* Cases
Collection Due Process	209	165	79%
Gross Income	108	60	56%
Failure to File Penalty	75	58	77%
Trade or Business Expense	67	46	69%
Frivolous Issues Penalty	67	64	96%
Negligence Penalty	57	33	58%
Family Status Issues	45	39	87%
Joint and Several Liability	45	27	60%
Summons Enforcement	44	20	45%
Trust Fund Recovery Penalty	34	8	24%
Total	**751**	**520**	**69%**

Table 3.I-02 demonstrates that taxpayers have a higher chance of prevailing in litigation if they are represented.

TABLE 3.I-02, OUTCOMES FOR *PRO SE* AND REPRESENTED TAXPAYERS

	Pro Se Taxpayers			*Represented Taxpayers*		
Most Litigated Issue	**Total Cases**	**Taxpayer Prevailed in whole or in part**	**Percent**	**Total Cases**	**Taxpayer Prevailed in whole or in part**	**Percent**
Collection Due Process	165	15	9%	44	9	20%
Gross Income	60	11	18%	48	14	29%
Failure to File Penalty	58	2	3%	17	3	18%
Trade or Business Expense	46	7	15%	21	9	43%
Frivolous Issues Penalty	64	17	27%	3	1	33%
Negligence Penalty	33	10	30%	24	8	33%
Family Status Issues	39	5	13%	6	2	33%
Joint and Several Liability	27	6	22%	18	6	33%
Summons Enforcement	20	0	0%	24	2	8%
Trust Fund Recovery Penalty	8	1	13%	26	12	46%
Totals	**520**	**74**	**14%**	**231**	**66**	**29%**

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

LITIGATED ISSUE #1 — APPEALS FROM COLLECTION DUE PROCESS (CDP) HEARINGS UNDER INTERNAL REVENUE CODE SECTIONS 6320 AND 6330

SUMMARY

Collection Due Process (CDP) hearings, established by the IRS Restructuring and Reform Act of 1998 (RRA 98), provide taxpayers an important opportunity for independent review by the Office of Appeals (Appeals) of the IRS's decision to file a lien or its proposal to undertake a levy action.[1] At the CDP hearing, the taxpayer has the statutory right to raise certain issues, including the appropriateness of collection actions, collection alternatives, spousal defenses, and under certain limited circumstances, the underlying tax liability.[2]

The taxpayer also has an automatic right to judicial review of Appeals' determination, provided that the taxpayer timely requests the CDP hearing and timely requests judicial review.[3] Generally, collection action is stayed during the CDP hearing process and any judicial review that may follow.[4]

As was the case in 2003 and 2004, Collection Due Process is the most frequently litigated tax issue in federal courts during the period analyzed for the Annual Report to Congress. CDP rights are a dramatic departure from the post-deprivation hearings that characterized IRS collection procedure utilized prior to RRA 98.[5] CDP has been criticized by many for slowing down the collection process and allowing a forum for some taxpayers to expound frivolous arguments. These critics contend that the costs of CDP are significant, while the benefits of CDP are few.[6] However, other commentators note that CDP hearings bring vital independent oversight to bear upon IRS tax collectors who are not infallible and whose collection powers are considerable.[7] The CDP cases litigated in the federal courts reflect that there is an element of truth to these competing points of view. On balance, we believe that collection appeal rights with limited judicial review protect taxpayers from arbitrary collection decisions. In the Key Legislative Recommendations section of this report, the National Taxpayer Advocate proposes significant changes to CDP legislation.[8]

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

[2] IRC §§ 6320(c) and 6330(c).

[3] IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B) set forth the time requirements for requesting a CDP hearing and IRC §§ 6320(c) and 6330(d) set forth the time requirements for obtaining judicial review of Appeals' determination.

[4] IRC § 6330(e)(1) provides that in general there is a suspension of levy actions during the CDP process (along with a corresponding suspension in the running of the collection statute of limitations). However, IRC § 6330(e)(2) allows the IRS to resume levy actions during judicial review upon a showing of "good cause."

[5] *Phillips v. Comm'r*, 283 U.S. 589 (1931) (holding that where there is adequate opportunity for judicial determination after levy there is no right to pre-levy hearings).

[6] Bryan T. Camp, *Failure of Collection Due Process, Pt. 1: The Collection Context*, 104 Tax Notes 969 (Aug. 30, 2004); Bryan T. Camp, *The Failure of CDP, Part 2: Why it Adds No Value*, 104 Tax Notes 1567 (Sept. 27, 2004); Bryan T. Camp, *The Costs of CDP*, 105 Tax Notes 1445 (Dec. 6, 2004).

[7] Leslie Book, *The Collection Due Process Rights: A Misstep or a Step in the Right Direction?*, 41 Hous. L. Rev. 1145 (2004).

[8] *See* Key Legislative Recommendation: *Restructuring and Reform of Collection Due Process Provisions, supra*.

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of a lien[9] filed by the IRS or a proposed levy action.[10] The purpose of CDP rights was to give taxpayers adequate notice of collection activity and a meaningful hearing before the IRS deprives them of property. The hearing allows the taxpayer an opportunity to raise issues germane to the collection of the tax, including:[11]

- Appropriateness of collection actions;[12]
- Collection alternatives such as installment agreement, offer in compromise, posting a bond or substitution of other assets;[13]
- Appropriate spousal defenses;[14] 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.[15]

A taxpayer may not reintroduce an issue that was raised and considered at a prior administrative or judicial hearing if the individual participated meaningfully in the prior hearing or proceeding.[16]

Procedurally, the IRS must provide notice to the taxpayer of the lien filing[17] and of its intent to levy.[18] The Notice of Federal Tax Lien must be provided to the taxpayer not more than five days after the day of the filing of the notice of the lien.[19] The Notice of Intent to Levy must be provided to taxpayers at least 30 days before the day of the levy.[20] The IRS is also required to notify the taxpayer of his or her right to a CDP hearing after the filing of the Notice of Federal Tax Lien (NFTL) and before any levy action can take place. In the case of a lien, the CDP hearing notice must be provided to the taxpayer not more than five days after the filing of the NFTL and must inform the taxpayer of his

9 IRC § 6320.

10 IRC § 6330.

11 Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3401, 112 Stat. 685; S. Rep. No. 105-174.

12 IRC §§ 6330(c)(2)(A)(ii) and 6320(c).

13 IRC §§ 6330(c)(2)(A)(iii) and 6320(c).

14 IRC §§ 6330(c)(2)(A)(i) and 6320(c).

15 IRC §§ 6330(c)(2)(B) and 6320(c).

16 IRC §§ 6330(c)(4) and 6320(c).

17 IRC § 6320(a).

18 IRC § 6331(d).

19 IRC § 6320(a)(2). The Notice of Federal Tax Lien can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or can be sent by certified or registered mail to the taxpayer's last known address.

20 IRC § 6331(d)(2). The Notice of Intent to Levy can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or can be sent by certified or registered mail to the taxpayer's last known address.

or her right to request a CDP hearing within the 30-day period that begins on the expiration of the fifth day after the filing of the NFTL.[21] In the case of a levy, the CDP hearing notice must be provided to the taxpayer no fewer than 30 days before the first levy and must inform the taxpayer of his or her right to request a hearing 30 days from the date that the notice is sent.[22]

Under both lien and levy procedures, the taxpayer must return a signed, written request for a CDP hearing within 30 days of the date of notice.[23] Taxpayers who request a CDP hearing after the 30 days will receive an "equivalent hearing," which is similar to a CDP hearing except there is no judicial review of an equivalent hearing.[24] Proposed revisions to the CDP regulations require the taxpayer to put the reasons for the CDP hearing in writing (preferably using Form 12153, *Request For A Collection Due Processs Hearing*), and the failure to provide the basis for hearing may result in a denial of a face-to-face hearing.[25] Proposed revisions also eliminate the availability for equivalent hearings if the taxpayer does not make a request for a hearing within one year from the date of issuance of the CDP Notice.[26]

When a taxpayer requests CDP hearings with respect to both a lien and a proposed levy, the IRS Appeals officer will attempt to conduct one hearing.[27] The IRS will suspend collection action throughout the hearing process, unless it determines that the collection of the tax is in jeopardy.[28] Collection activity is also suspended throughout any judicial review of Appeals' determination, unless the underlying tax liability is not at issue and the IRS can demonstrate to the court good cause to resume collection activity.[29]

Collection Due Process hearings are informal. The Office of Appeals presumptively establishes telephonic CDP hearings, and it is incumbent on the taxpayer to request a

21 IRC § 6320(a)(2).

22 IRC § 6330(a)(2). The CDP hearing notice can be provided to the taxpayer in person, left at the taxpayer's residence or dwelling, or can be sent by certified or registered mail (return receipt requested) to the taxpayer's last known address.

23 IRC §§ 6330(a)(3)(B) and 6330(a)(3)(B); Treas. Reg. § 301.6320-1(c) and Treas. Reg. § 301.6330-1(c).

24 Treas. Reg. § 301.6330-(1)(i).

25 Prop. Treas. Reg. § 301.6320-1 and Prop. Treas. Reg. § 301.6330-1. The proposed regulations provide taxpayers an opportunity to cure a failure to provide a basis for the CDP hearing.

26 *Id.*

27 IRC § 6320(b)(4).

28 IRC § 6330(e)(1) provides the general rule for suspending collection activity while IRC § 6330(f) provides that if collection of the tax is deemed in jeopardy, section 6330 does not apply.

29 IRC§ 6330(e)(1) and 6330(e)(2). In *Burke v. Comm'r*, 124 T.C. 189 (2005), the Tax Court granted the IRS's motion to levy while the case was on appeal since the taxpayer was espousing only frivolous arguments; *see also Howard v. Comm'r*, T.C. Memo. 2005-100, where the IRS moved for and obtained from the court an order allowing resumption in levy activity on the taxpayer due to the taxpayer's frivolous arguments made solely for the purpose of delaying collection.

face-to-face hearing.[30] Courts have determined that, depending on the circumstances, a CDP hearing need not be face-to-face with the Appeals officer,[31] but instead, can take place by telephone,[32] or by an exchange of correspondence.[33] The hearing is to be held by an impartial officer from the Appeals function of the IRS.[34] In addition to the issues described above that the taxpayer is permitted to address, the Appeals officer must obtain verification that the requirements of all laws and procedures have been satisfied for the IRS to proceed with collection activity.[35] In making its determination, Appeals must weigh the issues raised by the taxpayer and determine whether the proposed collection action balances the need for efficient collection of taxes with the legitimate concern of the taxpayer that any collection action be no more intrusive than necessary.[36] Within 30 days of the Appeals determination, the taxpayer may petition the United States Tax Court or where appropriate, the U.S. district court for judicial review of Appeals' determination.[37]

Where the validity of the tax liability is properly at issue in the CDP hearing, the amount of the tax liability will be reviewed by the appropriate court on a de novo basis.[38] Where the appropriateness of the collection action is at issue, the court will review the IRS's administrative determination for abuse of discretion.[39]

ANALYSIS OF LITIGATED CASES

Collection Due Process was the most litigated tax issue in the federal court system between June 1, 2004 and May 31, 2005. Two hundred and nine (209) CDP court deci-

30 Appeals Letter 3855. *See also* Treas. Reg. § 301.6320-1(d)(2) Q&A D6 and Treas. Reg. § 301.6320-1(d)(2) Q&A D6 regarding the informality of CDP hearings.

31 For example, in *Casey v. Comm'r*, T.C. Memo. 2004-228, the Tax Court held that a face-to-face hearing was not required where taxpayer had a reasonable opportunity for a hearing, but changed addresses and failed to provide the IRS her new address. However, in *Cavanaugh v. U.S.*, 93 A.F.T.R.2d (RIA) 2004-1522 (D. N.J. 2004), where the facts were disputed as to whether the taxpayer knew that phone conversations constituted the taxpayer's CDP hearing, the court remanded the case for Appeals to provide a face-to-face hearing.

32 In *Whiting v. Comm'r*, T.C. Memo. 2004-136, the Tax Court held that two phone conversations by the taxpayer's representative and the Appeals officer were sufficient to constitute a CDP hearing in the absence of testimony regarding the content of the phone conversations.

33 Treas. Regs. §§ 301.6320-1(d)(2), Q&A-D6 and 301.6330-1(d)(2), Q&A-D6.

34 IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1) and 6330(b)(3).

35 IRC § 6330(c)(1).

36 IRC § 6330(c)(3).

37 IRC §§ 6330(d)(1) and 6320(c).

38 The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing the IRS's administrative CDP determinations. H.R. Rep. No.105-599 at 266 (Conf. Rep.). The term *de novo* means anew. *Black's Law Dictionary*, 447 (7th ed. 1999).

39 *Robinette v. Comm'r*, 123 T.C. 85 (2004), *appeal docketed*, No. 04-4081 (8th Cir. Dec. 16, 2004) (noting that *abuse of discretion* means an adjudicator's decision which is arbitrary, capricious, clearly unlawful or without a sound basis in law or fact).

sions were reviewed.[40] Excluding unpublished bench opinions that were not included in prior years' statistics, this represents an eight percent increase from the 182 CDP cases from last year's analysis and a one percent decrease from the 199 CDP cases reported in 2003.[41] The 209 decided cases do not reflect the full measure of CDP litigation involving taxpayers and the IRS during the review period. Not all CDP cases result in decisions for or against taxpayers. For example, from June 1, 2004 to May 31, 2005, taxpayers filed approximately 1,098 CDP cases in the United States Tax Court and 114 cases in United States district courts.[42] Some cases are resolved through negotiated settlements while other taxpayers do not pursue their litigation after filing their petitions with the courts, resulting in dismissal of the action. While these 209 decided cases may not provide the full measure of all CDP litigation, they do provide useful insight into the costs and benefits of CDP by shedding light on the situations of taxpayers utilizing CDP. Table 1 in Appendix 3 provides a detailed listing of litigated CDP cases, including specific information about the types of taxpayers involved.

Litigation Success Rate

Taxpayers prevailed in whole or in part in 24 of the 209 cases reviewed (or approximately 11 percent). In 16 of the 209 cases (approximately 8 percent), courts either remanded the case to Appeals because issues of material fact remained, or ruled that the IRS abused its discretion.[43] Of the remaining eight cases where taxpayers prevailed, four involved the existence or amount of underlying liability or application of the relief from joint and several liability provisions under IRC § 6015,[44] and four cases involved procedural rulings.[45] Table 3.1.1 below compares litigation success rates in CDP cases for the 2002, 2003, and 2004 Reports to Congress.

[40] The cases reviewed for the Most Litigated Issues section of the report are those opinions that are published through on-line legal research services. In addition, the 209 litigated CDP opinions include 12 bench opinions issued pursuant to United States Tax Court Rule 152, wherein Tax Court Trial Judges or Special Trial Judges render oral findings of fact or opinion into the trial transcript. Bench opinions are not available through on-line research services and we did not have access to all bench opinions or orders of dismissal issued during this timeframe.

[41] *See* National Taxpayer Advocate 2003 Annual Report to Congress 318; National Taxpayer Advocate 2004 Annual Report to Congress 498.

[42] Statistics were provided by the Internal Revenue Service Office of Chief Counsel.

[43] *Berger v. Comm'r*, No. 19535-02L (Dec. 15, 2004); *Calderone v. Comm'r*, T.C. Memo. 2004-240; *Demus v. Comm'r*, No. 6636-04L (Dec. 15, 2004); *Fowler v. Comm'r*, T.C. Memo. 2004-163; *Jackson v. Comm'r*, T.C. Summ. Op. 2005-12; *Johnson v. Comm'r*, T.C. Summ. Op. 2005-47; *Karara v. Comm'r*, No. 7748-02L (Dec. 15, 2004); *Langer v. U.S.*, 95 A.F.T.R.2d (RIA) 894 (8th Cir. 2005); *Parker v. Comm'r*, T.C. Memo. 2004-226; *Pollack v. U.S.*, 327 F.Supp.2d 907 (W.D. Tenn. 2004); *Robinette v. Comm'r*, 123 T.C. 85 (2004), *appeal docketed*, No. 04-4081 (8th Cir. Dec. 16, 2004); *Skrizowski v. Comm'r*, T.C. Memo. 2004-229; *Thorpe v. Comm'r*, T.C. Summ. Op. 2004-98; *Zapara v. Comm'r*, 124 T.C. 223 (2005); *Cox v. U.S.*, 345 F.Supp.2d 1215 (W.D. Okla. 2004); *Newstat v. Comm'r*, T.C. Memo. 2004-208.

[44] *Hayes v. Comm'r*, T.C. Memo. 2005-57; *Hendricks v. Comm'r*, T.C. Memo. 2005-72; *Molina v. Comm'r*, T.C. Memo. 2004-258.

[45] *Beverly v. Comm'r*, T.C. Memo. 2005-41; *Klet v. Comm'r*, T.C. Summ. Op. 2004-172; *Smith v. Comm'r*, 124 T.C. 36 (2005); *Electro, Inc. v. Comm'r*, 95 A.F.T.R.2d (RIA) 700 (D. Or. 2005).

TABLE 3.1.1, CDP LITIGATION SUCCESS RATES

COURT DECISIONS	2002 Percentage	2003 Percentage	2004 Percentage	2005 Percentage
Decided for IRS	90%	96%	95%	**89%**
Decided for Taxpayer	7%	1%	4%	**8%**
Split Decision[46]	3%	3%	1%	**3%**

The increased litigation success rate for taxpayers in the 2004 - 2005 review period does not likely suggest any particular trend.

Issues Litigated

In 2004, we focused on the numerous procedural problems that taxpayers experienced with CDP hearings and judicial review of those hearings.[47] Taxpayers continued to experience these problems, and we discuss that issue further below. However, this year we focused more on the substantive issues raised by taxpayers in an effort to determine how useful CDP was for litigants and for tax administration. As was described above, taxpayers are able to raise a variety of issues at CDP hearings. It is essential for taxpayers to raise all relevant issues with Appeals so that the issue is preserved in the event it is necessary to pursue judicial review.[48] If the issue is not raised in the CDP hearing, it may not be raised on judicial review.[49] Table 3.1.2 below demonstrates the different issues raised by taxpayers and the frequency of success for each issue.[50]

46 A "split" decision refers to a case with multiple issues where both the IRS and the taxpayer prevail on one or more substantive issues.

47 National Taxpayer Advocate 2004 Annual Report to Congress 498.

48 Treas. Reg. § 301.6330-1(f) Q-AF5 provides:
Q-F5 What issue or issues may the taxpayer raise before the Tax Court or before a district court if the taxpayer disagrees with the Notice of Determination?
A-F5 In seeking Tax Court or other district court review of Appeals' Notice of Determination, the taxpayer can only ask the court to consider an issue that was raised in the taxpayer's CDP hearing.

49 *Id.*

50 The number of issues does not equal the number of cases reviewed for three reasons. First, for purposes of identifying issues, we did not take into consideration issues considered by the courts to have been frivolous or raised solely for the purpose of delay. Second, other cases had multiple issues. Third, numerous decisions addressed only threshold procedural questions and did not address the substantive issue raised by the taxpayer.

TABLE 3.1.2, SUCCESS OF LITIGANTS BY ISSUE[51]

Issue	No. Cases Issue Argued	IRS Prevailed	Taxpayer Prevailed
Collection Alternatives	40	35	**5**
Validity of Liability	39	33	**6**
Procedural Requirements	37	31	**6**
Abatement of Penalties	15	15	**0**
Payment of Liability[52]	9	7	**2**
Bankruptcy Issues	6	3	**3**
Abatement of Interest	5	4	**1**
Collection Statute Expiration	4	4	**0**
Relief from Joint & Several	2	1	**1**
Total:	**157**	**133**	**24**

Collection Alternatives

Collection alternatives were litigated more than any other CDP issue. Taxpayers have a statutory right to raise collection alternatives in their CDP hearings.[53] The two most frequently litigated collection alternatives were offers in compromise[54] and installment agreements.[55] Each of these collection alternatives requires current filing compliance on the taxpayer's part; offers in compromise additionally require that taxpayers remain in filing and payment compliance for an additional five years or until the liability is full paid, whichever is longer, or else the offer will be defaulted and the tax reinstated.[56] Courts review Appeals' consideration of collection alternatives, such as offers in compromise utilizing an abuse of discretion standard.[57]

Five taxpayers were able to demonstrate that the IRS abused its discretion when considering

[51] This count excludes numerous cases where taxpayers raised procedural issues that the courts deemed frivolous or groundless. *See e.g., Kubon v. Comm'r*, T.C. Memo. 2005-71 (the Secretary or delegate may issue collection notices, assessment was valid) *Henderson v. Comm'r*, T.C. Memo. 2004-157 (assessment was proper, notice of balance due/Notice of Intent to Levy meet requirement for notice and demand for payment).

[52] In these cases, taxpayers argued that previous payments, levies, or credits satisfied liabilities.

[53] IRC §§ 6330(c)(2) and 6320(c).

[54] Offers in compromise are provided for in IRC § 7122 and allow the IRS to compromise the taxpayer's liability based on doubt as to liability, doubt as to collectibility, and effective tax administration. Treas. Reg. § 301.7122-1.

[55] Installment agreements are provided for in IRC § 6159 and allow taxpayers who cannot immediately satisfy the liability to full-pay the liability in installments.

[56] *See* IRM § 5.14.1.5.1 for installment agreements; *see* § IRM 5.8.3.4.1 and IRS Form 656 for offers.

[57] *Robinette v. Comm'r*, 123 T.C. 85 (2004), *appeal docketed*, No. 04-4081 (8th Cir. Dec. 16, 2004).

their collection alternatives.[58] While relatively few in number (taxpayers prevailed in 13 percent of CDP cases in which collection alternatives were raised), these cases demonstrate the importance of judicial review to CDP rights as a check against arbitrary collection actions. For example, in *Johnson v. Commissioner*, Appeals rejected the proposed installment agreement of an individual who alleged that he was homeless (living in a temporary shelter), and Appeals determined to let levy action proceed against the taxpayer because he had failed to file two tax returns, although the taxpayer had given evidence that his income was insufficient to require the filing of those returns.[59] In *Fowler v. Commissioner*, the court held that the IRS abused its discretion in denying a taxpayer's offer in compromise proposal based on the Appeals officer's use of national expense standards to compute the taxpayer's expenses when the taxpayer's actual expenses were available.[60] In *Robinette v. Commissioner*, the Tax Court held that it was an abuse of discretion to default the taxpayer's offer in compromise (which requires that the taxpayer remain in compliance for five years) for the late filing of a tax return when the taxpayer's representative testified that he mailed the return and when the return reflected that the taxpayer was entitled to a refund.[61] These cases are examples of how judicial review can improve IRS collection policy by helping to instill more flexibility and common sense to its resolution practices.

Validity of the Underlying Liability

The next largest category of issues raised by taxpayers on judicial review was the validity of the taxpayer's underlying liability.[62] Taxpayers are able to argue the underlying liability in the CDP hearing and in *de novo* proceedings before the Tax Court if they did not receive a notice of deficiency or have a previous opportunity to argue the issue prior to the hearing.[63] In 26 of the 39 cases where the underlying liability was raised, courts found that the taxpayers had received a notice of deficiency or had had another opportunity to argue the underlying liability.[64] In three cases, however, courts made pre-trial rulings allowing taxpayers to argue the underlying liability where it appeared that the taxpayers

58 *Skrizowski v. Comm'r*, T.C. Memo. 2004-229 (holding it was an abuse of discretion to not fully investigate the OIC before rejecting it and not basing rejection on taxpayer's income, assets and allowable expenses and ability to pay. The court found that the taxpayer did not receive $5 million in business income reported on taxpayer's return when taxpayer was intoxicated when he submitted the delinquent return after allegedly being told by an IRS collections officer that he could go to jail if he did not file the return, and further noted that the Appeals officer did not believe the reported income was valid); *Cox v. U.S.*, 345 F.Supp.2d 1215 (W.D. Okla. 2004) (holding it was abuse of discretion to conclude that taxpayer could not make installment agreement payments when the company had been making payments on the tax); *Robinette v. Comm'r*, 123 T.C. 85 (2004), *appeal docketed*, No. 04-4081 (8th Cir. Dec. 16, 2004); *Fowler v. Comm'r*, T.C. Memo. 2004-163; *Johnson v. Comm'r*, T.C. Summ. Op. 2005-47.

59 *Johnson v. Comm'r, T.C.* Summ. Op. 2005-47.

60 *Fowler v. Comm'r*, T.C. Memo. 2004-163.

61 *Robinette v. Comm'r*, 123 T.C. 85 (2004), *appeal docketed*, No. 04-4081 (8th Cir. Dec. 16, 2004).

62 *See* Key Legislative Recommendation, *Restructuring and Reform of Collection Due Process Provisions, supra,* proposing elimination of *de novo* judicial review of the underlying liability in CDP cases.

63 IRC §§ 6320(c) and 6330(c)(2)(B); H.R. Rep. No. 105-599 at 266 (1998) (Conf. Rep.).

64 *See* Table 1 in Appendix 3 for a list of cases where the court found the taxpayer was not entitled to argue the underlying liability.

may have been denied an earlier opportunity to do so.[65] In three other cases, taxpayers successfully raised and prevailed on the issue of the underlying liability.[66]

Satisfaction of Procedural Requirements

The third largest category of CDP cases were taxpayers who argued that Appeals failed to follow all procedural requirements in offering and conducting the CDP hearing. In making its determination, Appeals is required to consider all issues raised by the taxpayer, and obtain verification that all laws and procedures have been followed to take the proposed collection action. In making its determination, Appeals must balance the need for efficient tax collection with the taxpayer's legitimate concern that any proposed collection alternative be no more intrusive than necessary.[67] The CDP statute and Treasury Regulations also impose notice and hearing procedural requirements on the IRS.[68]

Five taxpayers prevailed in their arguments that the IRS failed to follow all required procedural steps.[69] In *Cox v. Commissioner*, the court stressed the importance of CDP's procedural requirements, holding that the taxpayer was entitled to prior notice of the CDP hearing and that the taxpayer did not receive prior notice or any notice that two phone conversations constituted the CDP hearing.[70] The court emphasized the important role that adequate notice plays in the provision of CDP rights: Finally, although it is true that the Act does not import all federal due process protections into its requirements, it is also true that the opportunity to be heard at a meaningful time and in a meaningful manner is a bedrock principle of federal due process. *See Armstrong v. Manzo*, 380 U.S. 545, 552, 85 S.Ct. 1187, 14 L.Ed.2d 62 (1965) (a fundamental requirement of due

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[65] *Berger v. Comm'r*, No. 19535-02L (Dec. 15. 2004) (finding that taxpayer's signature signing for notice of deficiency appeared to be forged); *Calderone v. Comm'r*, T.C. Memo. 2004-240 (holding that taxpayer's representative may not have informed taxpayer about the notice of deficiency); *Newstat v. Comm'r*, T.C. Memo. 2004-208 (finding that there was no apparent record of a notice of deficiency for one year at issue).

[66] *Molina v. Comm'r*, T.C. Memo. 2004-258 (holding that distribution from retirement plan was not taxable in 2000); *Zelaya v. Comm'r*, T.C. Summ. Op. 2004-163 (holding that liability stemming from issuance of second refund check was invalid since evidence showed that check had been forged); *Langer v. U.S.*, 95 A.F.T.R.2d (RIA) 894 (8th Cir. 2005) (holding taxpayer not collaterally estopped from raising FICA tax issues in district court after improperly raising the issue in Tax Court).

[67] IRC § 6330(c)(3).

[68] *See* IRC §§ 6320(a) and 6330(a) governing notice requirements; *see also* Treas. Reg. §§ 301.6320 *et seq.* and 301.6330 *et seq.* governing the hearing procedure.

[69] *Demus v. Comm'r*, 6636-04L (Dec. 15, 2004) (remanding the case to Appeals to consider and address in the Notice of Determination all issues raised by taxpayer); *Karara v. Comm'r*, No. 7748-02L (Dec. 15, 2004) (holding taxpayer did not receive adequate CDP notice for tax year); *Parker v. Comm'r*, T.C. Memo. 2004-226 (when taxpayer requests face-to-face hearing, Appeals was required to hold hearing in closest Appeals office to taxpayer); *Pollack v. U.S.*, 327 F.Supp.2d 907 (W.D. Tenn. 2004), reconsidered at 95 A.F.T.R.2d 1191 (W.D.Tenn. 2004) (holding procedure not followed when Appeals Officer did not properly complete form prior to giving it to taxpayer in accordance with IRM; upon reconsideration, the court found that the notice of deficiency mailed to wrong address and the taxpayer could contest underlying liability); *Cox v. U.S.*, 345 F.Supp.2d 1215 (W.D. Okla. 2004) (holding notice of CDP hearing was inadequate).

[70] *Cox v. U.S.*, 345 F.Supp.2d 1218 (W.D. Okla. 2004).

process is the opportunity to be heard, granted at a meaningful time and in a meaningful manner). Inadequacy of notice of the hearing required by § 6330 inevitably impairs the protections which are explicitly provided for in that section.

Last year we reported numerous cases where taxpayers had objected to Appeals' refusal to allow them to record their CDP hearings notwithstanding the holding in *Keene v. Commissioner*, which recognized taxpayers' right to record hearings. Taxpayers continued to use this argument in an attempt to invalidate Appeals' determination; however, courts have demonstrated little inclination to remand a case on this basis where the taxpayer has failed to make other substantive arguments in the CDP process.[71] The IRS has changed its procedures to permit recording of CDP hearings when the hearing is face-to-face if certain requirements are met.[72] Taxpayers also continue to make similar arguments about the right to a face-to-face hearing, but courts have recognized there is no absolute right to a face-to-face hearing and are unwilling to remand the case back to Appeals on this basis where the taxpayer makes no other substantive arguments.[73]

Most taxpayers raising the argument of noncompliance with CDP procedures argued in general fashion that the IRS failed to adequately complete the verification requirements of IRC § 6330(c)(1). None of these taxpayers prevailed.[74]

Taxpayers continued to demonstrate confusion with procedural aspects of CDP. Appeals from CDP hearings relating to income taxes are appealed to the Tax Court, while employment taxes and certain penalty appeals, such as the IRC § 6702 frivolous return penalty, are made to the appropriate district court.[75] At least ten of the taxpayers filed their appeals in the wrong court.[76] As we described in last year's report, judicial review would be greatly simplified if jurisdiction was consolidated in the Tax Court.[77]

71 *Borchardt v. Comm'r*, 338 F.Supp.2d 1040 (D. Minn. 2004).

72 IRM § 8.6.1.2.5

73 *Casey v. Comm'r*, T.C. Memo. 2004-228; *Chandler v. Comm'r*, T.C. Memo. 2005-99; *Gardner v. Comm'r*, 95 A.F.T.R.2d (RIA) 2023 (D. N.J. 2005); *Quigley v. Comm'r*, 358 F.Supp.2d 427 (E.D. Pa. 2004). *See also*, Treas. Reg. § 601.106(b), providing in part "the appeal procedures do not extend to cases involving solely the failure or refusal to comply with the tax laws because of moral, religious, political, constitutional, conscientious, or similar grounds."

74 *See* Table 1, Appendix 3 for cases where this argument was made. Additionally, many of the taxpayers whose arguments were deemed "frivolous" or made solely for the purpose of delay also raised the verification argument.

75 IRC §§ 6330(d)(1) and 6320(c).

76 *Israel v. U.S.*, 93 A.F.T.R.2d (RIA) 2044 (S.D. Iowa 2005); *Kupcho v. Comm'r*, 95 A.F.T.R.2d (RIA) 1439 (D. N.J. 2005); *Mackinnon v. Fredrickson*, 95 A.F.T.R.2d (RIA) 1973 (D. Or. 2005); *Peterson v. Kreidich*, 95 A.F.T.R.2d (RIA) 2416 (11th Cir. 2005); *Rustam v. Comm'r*, T.C. Memo. 2005-42; *Torczon v. Lucas*, 95 A.F.T.R.2d (RIA) 681 (9th Cir. 2005); *Updegrave v. U.S.*, 94 A.F.T.R.2d (RIA) 6155 (D. Or. 2005); *Burns v. U.S.*, 95 A.F.T.R.2d (RIA) 1160 (M.D. Tenn. 2005); *Canaday v. U.S.*, 94 A.F.T.R.2d (RIA) 6311 (S.D. W.Va. 2004); *Cobin v. Comm'r*, A.F.T.R.2d (RIA) 717 (D. S.C. 2005).

77 National Taxpayer Advocate 2004 Annual Report to Congress 502; *see also* Key Legislative Recommendation: *Restructuring and Reform of Collection Due Process Provisions, supra*.

Penalty Abatement

Taxpayers can request the abatement of penalties in CDP hearings provided that the taxpayer has not previously had an opportunity to raise the issue.[78] The most frequently litigated penalties that taxpayers sought to abate through CDP hearings were:

- **IRC § 6651:** The penalty for failure to file a timely tax return penalty pursuant to IRC § 6651 can be abated by demonstrating that the failure to file was due to reasonable cause, and courts review the issue on a *de novo* standard.[79] Jurisdiction for judicial review from CDP hearings pertaining to the failure to file penalty applicable to income tax returns is with the Tax Court.[80] In cases where taxpayers sought abatement of the failure to file penalty, the issue was raised in conjunction with other issues, and none of the taxpayers were able to demonstrate reasonable cause.[81]
- **IRC § 6702:** The frivolous return penalty under IRC § 6702 is assessed against taxpayers who file a tax return that does not contain substantially correct information due to a position taken by the taxpayer that is frivolous or is based on a desire to impede or delay the administration of federal taxes.[82] Jurisdiction for judicial review from CDP hearings pertaining to the frivolous income tax return penalty is with the appropriate United States district court.[83] The reviewed decisions reflected a disagreement among the courts about the standard of review for this type of penalty (i.e. *de novo* or abuse of discretion).[84] All of the taxpayers assessed these penalties had filed returns showing zeroes in the boxes where taxable income is reported, and none of these taxpayers raised meritorious issues on appeal.[85]

78 IRC §§ 6320(c) and 6330(c)(4) provide that taxpayers are precluded from raising issues in a CDP hearing if the issue was raised in any other administrative or judicial proceeding, provided that the person meaningfully participated in the proceeding.

79 *Goza v. Comm'r*, 114 T.C. 176 (2000).

80 IRC § 6330(d)(1)(A) and (B).

81 Most of these taxpayers failed to offer any evidence on reasonable cause. *See Conner v. Comm'r*, T.C. Summ. Op. 2005-27; *Seavey v. Comm'r*, T.C. Summ. Op. 2005-8; *but see Jackson v. Comm'r*, T.C. Summ. Op. 2005-12 (holding that taxpayers failed to prove that the IRS agreed to abate penalties).

82 IRC § 6702(a)(1)-(2).

83 IRC § 6330(d)(1)(A) and (B); *see Hoffman v. U.S.*, 209 F.Supp.2d 1089 (W.D. Wash. 2002).

84 *Le Doux v. U.S.*, 375 F.Supp.2d 1242 (D. N.M. 2005). In *Le Doux*, the court noted that some courts have held that a frivolous penalty is reviewed on a *de novo* standard, citing *Lemieux v. U.S.*, 230 F.Supp.2d 1143 (D. Nev. 2002), while other courts have held that the standard is abuse of discretion, *citing Carroll v. U.S.*, 217 F.Supp.2d 852 (W.D. Tenn. 2002). The court in *Le Doux* held that under either standard the taxpayers had filed a frivolous return.

85 *Gardner v. U.S.*, 95 A.F.T.R.2d (RIA) 2023 (D. N.J. 2005); *Herip v. U.S.*, 95 A.F.T.R.2d (RIA) 537 (6th Cir. 2004); *Holmes v. U.S.*, 351 F.Supp.2d 526 (W.D. La. 2004); *McCurdy v. U.S.*, 95 A.F.T.R.2d (RIA) 2776 (D. Mass. 2005); *Meyer v. Comm'r*, 95 A.F.T.R.2d (RIA) 2471 (W.D. WI 2005)(incurring additional Rule 11 sanctions for making frivolous arguments); *Quigely v. U.S.*, 358 F.Supp.2d 427 (E.D. PA 2004); *Ray v. U.S.*, 94 A.F.T.R.2d (RIA) 5925 (W.D. Mo. 2004); *Schultz v. U.S.*, 95 A.F.T.R.2d (RIA) 1977 (W.D. MI 2005); *Sergio v. U.S.*, 95 A.F.T.R.2d (RIA) 1174 (2005); *Turner v. U.S.*, 372 F.Supp.2d 1053 (S.D. Ohio 2005); *Updegrave v. U.S.*, 94 A.F.T.R.2d (RIA) 6155 (D. Or. 2004).

Application of Payments

Taxpayers also argued that payments, levies, or credits satisfied all or part of the outstanding liabilities and the IRS misapplied their payments. Taxpayers prevailed on this issue in two of six cases. In *Hayes v. Commissioner*, the taxpayers and the IRS disagreed about whether the disputed liability had been paid. Before trial, however, the IRS's counsel discovered that the IRS had misapplied the taxpayer's payment to a different year and disclosed this fact to the court.[86] In *Zapara v. Commissioner*, the Tax Court held that pursuant to IRC § 6335(f)[87] taxpayers were entitled to a credit for the value of stock accounts, which had been seized, as of the date which the IRS was required to sell the stock, having been requested to do so by the taxpayers.[88]

Bankruptcy

Some CDP cases raised the automatic stay provisions and discharge provisions of the Bankruptcy Code. When a taxpayer files a petition in bankruptcy court, there is an automatic stay on the commencement or continuation of any judicial or administrative proceeding against the debtor that was or could have been started before the commencement of the bankruptcy case.[89] Over the past year, the Tax Court dealt with different scenarios involving the interaction of taxpayers' CDP cases and their bankruptcy petitions. In *Smith v. Commissioner*, the Tax Court found that it did not have jurisdiction, holding that Appeals' Notice of Determination was issued in violation of the automatic stay where the taxpayer filed his bankruptcy petition after his CDP hearing but before Appeals' determination, thus invalidating the determination.[90] The automatic stay worked to the taxpayer's disadvantage in *Prevo v. Commissioner*, where the Tax Court held that it had no jurisdiction when the taxpayer filed a bankruptcy petition after the Notice of Determination was issued, but before petitioning the Tax Court. The Court stated that this was a "trap for the unwary," noting the absence of a tolling provision in IRC §§ 6320 or 6330 comparable to IRC § 6213(f).[91] The National Taxpayer Advocate recommended a legislative change in the 2004 Annual Report[92] to fix this unintended result.

In general, tax liabilities for taxable years in which a return was due, including extensions, within three years of the date of the filing of the bankruptcy petition may not be

[86] *Hayes v. Comm'r*, T.C. Memo. 2005-57.

[87] IRC § 6335(f) requires the IRS to sell seized property within 60 days of the request by taxpayers.

[88] *Zapara v. Comm'r*, 124 T.C. 223 (2005).

[89] 11 U.S.C.A. § 362(a).

[90] *Smith v. Comm'r*, 124 T.C. 36 (2005); *see also Beverly v. Comm'r*, T.C. Memo. 2005-41 (invalidating the IRS's Notice of Intent to Levy where it was issued after the filing of taxpayer's bankruptcy petition).

[91] *Prevo v. Comm'r*, 123 T.C. 326 (2004). Other taxpayers were unsuccessful in attempting to use the automatic stay to shield them from collection actions. *Meadows v. Comm'r*, 405 F.3d 949 (11th Cir. 2005) (holding that application of wife's $10,000 offer-in-compromise payment to debt that was later discharged in bankruptcy was not a violation of the automatic stay from taxpayer's previous bankruptcy filing).

[92] National Taxpayer Advocate 2004 Annual Report to Congress 490.

discharged in bankruptcy.[93] One taxpayer unsuccessfully argued that his liabilities were discharged, but the Tax Court determined that the taxes were not discharged and were not dischargeable. The court determined that the tax liabilities for several years at issue were liabilities for which returns were due (including extensions) within three years of the filing of the bankruptcy petition and thus, were not dischargeable. The tax liability for the remaining year was not dischargeable because the due date for the return (including extensions) for the year at issue was after the date that the bankruptcy petition was filed.[94]

Interest Abatement

In CDP hearings, taxpayers may raise the issue of abatement of interest from the liability pursuant to IRC § 6404(e), which allows the IRS to abate interest attributable to unreasonable error or delay resulting from a ministerial or managerial act.[95] Courts review the Appeals' determination on abatement of interest utilizing an abuse of discretion standard.[96] In one case, the taxpayer was able to demonstrate that the IRS unreasonably delayed in providing the taxpayer an escrow demand letter, which the taxpayer needed so that he could finance the repayment of the tax liability.[97]

Collection Statute Expiration

Generally, the IRS has ten years from the date of assessment to collect a tax.[98] The running of the ten-year collection period is suspended on the occurrence of certain events, including the filing of a CDP hearing request[99] and the submission by taxpayers of offers-in-compromise or installment agreements.[100] Four taxpayers raised the expiration of the statute of limitations as a defense to the imposition of collection action; none prevailed.[101]

93 11 U.S.C.A. §§ 523(a)(1)(A) and 507(a)(8)(A)(i).

94 *Klet v. Comm'r*, T.C. Summ. Op. 2004-172.

95 IRC § 6404(e); Treas. Reg. § 1.6404-2(a)(2).

96 *Woodral v. Comm'r*, 112 T.C. 19 (1999).

97 *Jackson v. Comm'r*, T.C. Summ. Op. 2005-12 (holding in a split decision that some of the accrued interest was attributable to the IRS's delay in providing taxpayer an escrow demand letter and also holding that Appeals had not abused its discretion in refusing to abate penalties).

98 IRC § 6502(a)(1).

99 When a CDP hearing is elected, the suspension of the collection statute exists until the hearing and any related appeals are concluded. IRC § 6330(e)(1).

100 The collection statute is suspended while offers-in-compromise and installment agreements are pending. IRC § 6331(i)(5) and (k)(1)-(2).

101 *Van Dyke v. Comm'r*, T.C. Summ. Op. 2005-5; *Griffith v. Comm'r*, T.C. Memo. 2004-267; *Picchiottino v. Comm'r*, T.C. Memo. 2004-231; *Picchiottino v. Comm'r*, T.C. Memo. 2004-232.

Relief From Joint and Several Liability On Joint Returns

Relief from joint and several liability on joint returns pursuant to IRC § 6015 is also a Most Litigated Issue for this year's report. Taxpayers have the option to raise these issues in CDP hearings.[102] Two taxpayers litigated the Appeals determination on IRC § 6015 issues in CDP hearings, with one taxpayer prevailing.[103]

Pro Se Analysis

One hundred and sixty-five (or 79 percent) of the 209 cases litigated were brought before the courts by the taxpayer, *pro se*, without benefit of counsel. This is a modest increase from 74 percent in the previous year.[104] Table 3.1.3 shows the breakdown of *pro se* and represented taxpayers and the decisions rendered by the court, indicating that approximately nine percent of *pro se* taxpayers receive some relief on judicial review while 20 percent of represented taxpayers received full or partial relief from their CDP appeals.

TABLE 3.1.3, SUCCESS RATES AND REPRESENTATION

Court Decisions	*Taxpayer Pro Se*		*Representation*	
	Volume	Percentage of Total	Volume	Percentage Of Total
Decided for IRS	150	91%	35	**80%**
Decided for Taxpayer	10	6%	8	**18%**
Split Decision	5	3%	1	**2%**
Totals:	**165**	**100%**	**44**	**100%**

CONCLUSION

CDP continues to be the most litigated issue in federal tax courts. This volume is due in part to the breadth of issues that can be raised in CDP hearings. Despite weaknesses in the CDP legislation, we think CDP and judicial oversight of the collection process serves as an important check on the IRS and balances the taxpayers' concerns about collection action with the government's need to collect taxes. We have attempted to address these weaknesses in a Key Legislative Recommendation in this year's report so that the value of CDP is preserved.

102 IRC § 6330(c)(2)(A)(i).

103 *Zachry v. Comm'r*, T.C. Summ. Op. 2005-55; *Hendricks v. Comm'r*, T.C. Memo. 2005-72.

104 National Taxpayer Advocate 2004 Annual Report to Congress 509.

LITIGATED ISSUE #2 GROSS INCOME UNDER INTERNAL REVENUE CODE SECTION 61 AND RELATED CODE SECTIONS

SUMMARY

Gross income is the starting point for computing taxable income and the amount of tax that must be paid. The issue of what constitutes gross income under IRC § 61 is once again a most litigated issue, as it has been in each of the National Taxpayer Advocate's Annual Reports to Congress. The cases reviewed for this report involved whether income was includible in taxable gross income, whether the Internal Revenue Code (IRC) specifically excluded an item of income, and whether taxpayers reported the correct amount of income. While the cases touched on a variety of issues, the four most prevalent were:

- Awards and settlements;
- Disability and Social Security benefits;
- Constructive dividends; and
- Unreported income.

PRESENT LAW

IRC § 61 broadly defines gross income as "all income from whatever source derived."[1] The courts also construe this provision broadly, categorizing income as "any accession to wealth."[2] However, the Code excludes many specific items from gross income,[3] and the courts construe these exclusions narrowly.[4]

ANALYSIS OF LITIGATED CASES

This analysis covers cases involving gross income that were decided in the federal court system between June 1, 2004, and May 31, 2005.[5] The 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 Annual Report to Congress for fiscal years 2002, 2003 and 2004.[6] Table 2 in Appendix 3 provides a detailed listing of the cases analyzed for this report.

1 IRC § 61(a).

2 *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955).

3 *See e.g.*, IRC §§ 104, 105, and 108.

4 *Comm'r v. Schleier*, 515 U.S. 323 (1995).

5 The methodology used to identify income cases was based on a review of federal cases involving IRC § 61.

6 National Taxpayer Advocate 2002 Annual Report to Congress 260-271; National Taxpayer Advocate 2003 Annual Report to Congress 332-351; and National Taxpayer Advocate 2004 Annual Report to Congress 511-523.

AWARDS AND SETTLEMENTS

Taxation of settlements and judgments remains a frequently litigated issue. Taxpayers disagree with the IRS over whether the award or a portion of the award qualifies for exclusion from gross income as an amount "received on account of personal physical injuries or physical sickness"[7] and whether the attorney fee portion of the award or settlement is includible in gross income.

The Supreme Court's decision in *Commissioner v. Banks* clarifies the tax treatment of *contingent* attorney fees only, holding that generally, when a litigant's recovery of damages constitutes income, contingent attorney's fees should be included in the taxpayer's gross income.[8]

In 2004, Congress passed legislation addressing the deductibility of attorneys' fees and court costs in discrimination suits, effective for awards received after October 22, 2004.[9] The new provision allows an "above the line" deduction not to exceed the amount of the judgment or settlement. This means that attorney fees in discrimination cases are generally deducted from gross income when computing adjusted gross income.[10] For contingent fee awards in discrimination cases received on or before October 22, 2004, the taxpayer must include the fee in gross income and deduct it as a miscellaneous itemized deduction, subject to a reduction by two percent of the taxpayer's adjusted gross income and Alternative Minimum Tax (AMT).[11]

IRC § 104(a)(2)

Under IRC § 104(a)(2), the award (other than punitive damages) is excluded from gross income if the judgment or settlement is "on account of personal physical injuries or physical sickness."[12] This exclusion can lead taxpayers to structure judgments or settlements to reflect compensation for physical injuries, rather than other forms of damages not eligible for the exclusion. Nine opinions were issued this year on whether an award was "on

[7] IRC § 104(a)(2) excludes from gross income damages (other than punitive damages) received "on account of personal physical injuries or physical sickness."

[8] *Comm'r v. Banks*, 543 U.S. 426, 125 S. Ct. 826 (2005).

[9] On October 22, 2004, the President signed into law H. R. 4520, the American Jobs Creation Act of 2004. Section 703, Civil Rights Tax Relief, provides relief from the double taxation of attorneys' fees and court costs awarded to plaintiffs in lawsuits for unlawful discrimination. The new law allows an "above the line" deduction of these amounts for adjusted gross income (AGI), thus effectively subtracting these amounts for purposes of the taxable income of the plaintiff.

[10] IRC § 62(a)(19).

[11] *Comm'r v. Banks*, 543 U.S. 426, 125 S. Ct. 826, 830-31 (2005); IRC § 67– limitation on miscellaneous itemized deductions. *See* description of contingent attorney fees, *infra* for more analysis of *Banks* and its implications.

[12] IRC § 104(a)(2).

account of personal physical injuries or physical sickness."[13] Taxpayers lost all nine cases.

Courts interpret § 104(a)(2) very narrowly.[14] In *Vincent v. Commissioner*, the taxpayer received a settlement in a wrongful termination suit. The taxpayer alleged she missed work due to an ulcer, and the settlement agreement allocated $240,000 of the settlement award for "personal injuries and emotional distress." The court looked to the underlying claim, and held that despite the wording of the settlement agreement, the award was really for discrimination and not "personal physical injuries" and the award was includible in gross income.[15]

In *Murphy v. IRS*, the taxpayer sued the New York National Guard for employment discrimination. The taxpayer offered medical testimony that she experienced physical injuries, including teeth grinding, due to the discrimination. The taxpayer later settled the case, and the agreement allocated $45,000 of the award to "mental pain and anguish."[16] The court held this award did not qualify for the § 104(a)(2) exclusion, as "mental pain and anguish" is not a physical injury even when it leads to a physical injury, and hence the award was fully taxable.[17]

Contingent Attorneys' Fees

For those awards not excludable under IRC § 104(a)(2), the issue has arisen as to whether the attorney fees portion of a taxable award is also includible in gross income. In *Commissioner v. Banks*, the Supreme Court held that generally, when a plaintiff's settlement or judgment constituted income, the plaintiff's income includes the portion of the judgment or settlement allocated to attorney fees as a contingent fee. The court did not address the issue of claims brought under federal statutes that authorize fee awards to attorneys, stating that because the attorney's fees in *Banks* were paid on the basis of a contingent fee contract, it was unnecessary to address the taxation of attorneys' fees that could have been awarded under federal statute.[18] Before the Supreme Court decision in *Banks*, the lower courts were split on the tax treatment of attorney fees.[19] The Fifth, Sixth, and Eleventh Circuits held that the contingent fee portion of a judgment or settlement should not be included in plaintiff's gross income. Six other circuits held that such fees are includible in gross income, with some circuits relying on state law property

13 *Bolden v. Comm'r*, T.C. Summ. Op. 2004-114; *Brooks v. U.S.*, 383 F.3d 521 (6th Cir. 2004); *Henderson v. Comm'r*, 94 A.F.T.R.2d 5246 (9th Cir. 2004); *Kidd v. Comm'r*, T.C. Memo. 2004-135; *Murphy v IRS*, 362 F.Supp. 2d 206 (D.D.C. 2005); *Ndirika v. Comm'r*, T.C. Memo. 2004-250; *Valia v. Comm'r*, T.C. Summ. Op. 2005-17; *Vincent v. Comm'r*, T.C. Memo. 2005-95.

14 *Kidd v. Comm'r*, T.C. Memo. 2004-135.

15 *Vincent v. Comm'r*, T.C. Memo. 2005-95.

16 *Murphy v. IRS*, 362 F.Supp.2d 206, 210 (D.D.C. 2005).

17 *Id.*

18 *Comm'r v. Banks*, 543 U.S. 426, 125 S. Ct. 826 (2005).

19 *Id.*

interests while others disregarded state law.[20] In *Banks*, the Supreme Court held that the contingent attorneys' fees portion of the settlement was taxable income to the plaintiff under the anticipatory assignment of income doctrine.[21]

Inclusion in gross income of contingent attorney fees that the individual plaintiff never receives can cause inequitable results because of the way the Internal Revenue Code deals with the corresponding deduction of the fees. While taxpayers can deduct the full amount of attorney fees they are required to take into income, many taxpayers are adversely affected because the deductions are treated as miscellaneous itemized deductions.[22] Miscellaneous itemized deductions are deductible only if the taxpayer itemizes, and are subject to a two percent floor under IRC § 67. More importantly, miscellaneous itemized deductions are not taken into account for purposes of computing the AMT.[23] Therefore, the taxpayer may end up paying more in taxes than the amount of the award settlement he or she actually received for awards received on or before October 22, 2004.[24]

In *Banks* and its companion case, *Commissioner v. Banaitis*, the taxpayers received settlement awards and their attorneys received portions of the awards under contingent fee arrangements.[25] The taxpayers argued that because applicable state law granted the attorney a property interest in the contingent fee portion of the award, the taxpayer should not have to include the contingent fee in gross income. The Supreme Court rejected that argument, holding that amounts representing the contingent attorney fee portions of the awards are includible in the plaintiff's gross income because the fee arrangement was an "anticipatory assignment of income." The Court reasoned that "income should be taxed to the party who earns the income and enjoys the consequent benefits."[26] State property laws do not change the fundamental principal-agent nature of the attorney-client relationship, and are thus irrelevant.[27]

The Supreme Court decision in Banks requires that if the settlement or judgment constitutes income, i.e. the award does not fall under the exclusion under IRC § 104(a)(2) for

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20 *Comm'r v. Banks*, 543 U.S. 426, 125 S. Ct. 826 (2005).

21 *Id.* at 830-31.

22 *Biehl v. Comm'r*, 351 F.3d 982, 984 (9th Cir. 2003).

23 IRC § 56(b)(1)(A)(i).

24 *See* National Taxpayer Advocate's 2004 Annual Report to Congress 517, footnote 47, citing David G. Savage, *A Win-Lose Situation*, 90 A.B.A.J., 18 (Nov. 2004), discussing *Spina v. Forest Preserve District of Cook County*, 207 F.Supp.2d 764 (N.D. Ill. 2002) where the taxpayer received a $300,000 award and her attorneys received $1 million in fees, all of which was taxed to the taxpayer, resulting in a tax liability that exceeded her award by $99,000.

25 *Comm'r v. Banks*, 125 S. Ct. at 829-30; *Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003). In *Banitis v. Commissioner*, an Oregon case, the court ruled that the state law afforded a property interest in the settlement and therefore portion of the settlement paid directly for attorney fees was excluded from income.

26 *Comm'r v. Banks*, 125 S. Ct. at 830.

27 *Id.*

personal physical injury or physical sickness or the exclusion under IRC § 62(a)(19) for claims involving unlawful discrimination paid after October 22, 2004, taxpayers report as gross income the contingent attorney fee portion of these awards, even in cases in which the taxpayer never actually receives that amount or is legally entitled to receive it.[28] The Tax Court relied on the *Banks* decision in deciding two subsequent contingent fee cases.[29]

DISABILITY AND SOCIAL SECURITY BENEFITS

As workers age and retire, wage income is often replaced by other forms of income, such as disability benefits, Social Security, and tax-advantaged retirement income. Because these forms of income can be wholly or partially excludible from gross income, taxpayers and the IRS frequently litigate the characterization of certain of these payments. This year, courts issued 26 opinions, compared with 11 last year.[30]

Disability Income

We reviewed six cases in which taxpayers claimed that some sort of disability benefits were excludible from income under IRC §§ 104 or 105.[31] Two cases involving military pension income illustrate how narrowly courts interpret the statutory exclusions for disability payments.[32] In *Hintz v. Commissioner*, the taxpayer, a retired U.S. Army infantryman, claimed he should be able to exclude his disability pension income from the Department of Defense. The Tax Court held for the IRS, as there was no evidence the taxpayer's disability stemmed from combat, a requirement for the exclusion under IRC § 104(b)(2)(C).[33]

28 In response to the pending litigation, the American Jobs Creation Act of 2004, § 703, Pub. L. No. 108-357, 118 Stat. 1418, 1546 (2004), enacted IRC § 62(a)(19) to allow an "above-the line" deduction for attorney fees in awards or settlements of certain claims of "unlawful discrimination." As a result, the deduction is taken before adjusted gross income is computed and is not subject to either IRC § 67 or AMT. However, contingent attorney fee portions of other judgments or settlements of cases not specified in the statute are subject to the Banks rule.

29 The Tax Court cited *Banks* in *Williams v. Comm'r*, T.C. Memo. 2005-29 (taxpayers must include in gross income 40 percent attorneys' fee from employment discrimination settlement), and *Vincent v. Comm'r*, T.C. Memo. 2005-95 (attorney fee portion of the settlement includible in gross income).

30 *Barkley v. Comm'r*, T.C. Memo. 2004-287; *Buras v. Comm'r*, T.C. Summ. Op. 2004-161; *Cawvey v. Comm'r*, T.C. Summ. Op. 2005-63; *Cohen v. Comm'r*, T.C. Memo. 2004-227; *Dirks v. Comm'r*, T.C. Memo. 2004-138; *Dotson v. Comm'r*, T.C. Summ. Op. 2004-164; *Davis v. Comm'r*, T.C. Summ. Op. 2005-61; *Flores v. Comm'r*, T.C. Summ. Op. 2005-57; *Hayden v. Comm'r*, 95 A.F.T.R.2d 1918 (9th Cir. 2005); *Headen v. Comm'r*, T.C. Summ. Op. 2005-33; *Hintz v. Comm'r*, T.C. Summ. Op. 2005-43; *Kellum v. Comm'r*, T.C. Summ. Op. 2005-29; *Klingaman v. Comm'r*, T.C. Summ. Op. 2005-36; *Mitchell v. Comm'r*, T.C. Summ. Op. 2004-160; *Molina v. Comm'r*, T.C. Memo. 2004-258; *Olson v. Comm'r*, T.C. Memo. 2004-197; *Peters v. Comm'r*, T.C. Summ. Op. 2005-42; *Reimels v. Comm'r*, 123 T.C. 245 (2004); *Seidel v. Comm'r*, T.C. Memo. 2005-67; *Seidel v. Comm'r*, T.C. Summ. Op. 2005-51; *Sternberg v. I.R.S.*, 95 A.F.T.R.2d 402 (2nd Cir. 2005); *Werts v. Comm'r*, T.C. Summ. Op. 2005-34; *White v. Comm'r*, T.C. Summ. Op. 2005-62; *Widemon v. Comm'r*, T.C. Memo. 2004-162; *Wright v. Comm'r*, T.C. Memo. 2005-5; *Youngblood v. Comm'r*, T.C. Memo. 2005-43; National Taxpayer Advocate 2004 Annual Report to Congress 599-600.

31 *Hayden v. Comm'r*, 95 A.F.T.R.2d 1918 (9th Cir. 2005); *Hintz v. Comm'r*, T.C. Summ. Op. 2005-43; *Kellum v. Comm'r*, T.C. Summ. Op. 2005-29; *Reimels v. Comm'r*, 123 T.C. 245 (2004); *Wright v. Comm'r*, T.C. Memo. 2005-5; *Youngblood v. Comm'r*, T.C. Memo. 2005-43.

32 *Hintz v. Comm'r*, T.C. Summ. Op. 2005-43; *Reimels v. Comm'r*, 123 T.C. 245 (2004).

33 *Hintz v. Comm'r*, T.C. Summ. Op. 2005-43.

In *Reimels v. Commissioner*, the taxpayer, disabled by Agent Orange exposure in Vietnam, claimed that his Social Security disability insurance benefits were excluded from gross income under § 104(a)(4), which excludes payments received for personal injury or sickness resulting from active military service. The Tax Court held his Social Security disability income was not excludible because the taxpayer received it because he was disabled, and it did not matter to Social Security that the disability resulted from his military service.[34]

Social Security Benefits

The IRS prevailed in six cases dealing directly with the taxation of Social Security benefits under IRC § 86.[35] Depending on the taxpayer's adjusted gross income and filing status, Social Security may be treated in one of three ways: excluded entirely from gross income, 50 percent included in gross income, or 85 percent included in gross income.[36] This is not the only complexity taxpayers face when dealing with the taxation of their Social Security benefits.[37] For example, when a person receives both worker's compensation and Social Security, the Social Security Administration pays the recipient less due to his or her receiving worker's compensation.[38] This reduction is known as the "worker's compensation offset."[39] Treating the offset as Social Security converts otherwise tax-free worker's compensation into potentially taxable income.[40] In both *Cawvey v. Commissioner* and *Flores v. Commissioner*, the Tax Court agreed with the IRS that the worker's compensation offset was includible in gross income under IRC § 86(d)(3).[41] The court expressed sympathy for the taxpayer in *Flores* but was bound by the law as written by Congress.[42]

Tax-Advantaged Retirement Accounts

We reviewed 14 cases dealing with tax-advantaged retirement income and accounts, such

[34] *Reimels v. Comm'r*, 123 T.C. 245 (2004).

[35] *Cawvey v. Comm'r*, T.C. Summ. Op. 2005-63; *Davis v. Comm'r*, T.C. Summ. Op. 2005-61; *Flores v. Comm'r*, T.C. Summ. Op. 2005-57; *Headen v. Comm'r*, T.C. Summ. Op. 2005-33; *Klingaman v. Comm'r*, T.C. Summ. Op. 2005-36; *Werts v. Comm'r*, T.C. Summ. Op. 2005-24.

[36] IRC § 86.

[37] *See* Richard M. Colombik, *Social Security Benefits: How Much is Taxable*, 14-SUM Experience 44 (Summer 2004), discussing the complexity of Social Security taxation, which can vary based on the taxpayer's "other sources and amounts of income" and concluding that most taxpayers receiving Social Security will need either a computer or a tax preparer to determine the amount of taxable benefits.

[38] IRC § 86(d)(3); *See Cawvey v. Comm'r*, T.C. Summ. Op. 2005-63; *Flores v. Comm'r*, T.C. Summ. Op. 2005-57.

[39] *Cawvey v. Comm'r*, T.C. Summ. Op. 2005-63.

[40] IRC § 86(d)(3). Worker's compensation is generally excludible from gross income under IRC § 104(a)(1). Treating the offset as Social Security under IRC § 86 makes the offset amount, which is worker's compensation, potentially fifty or eight-five percent includible in gross income, depending on the taxpayer's adjusted gross income.

[41] *Cawvey v. Comm'r*, T.C. Summ. Op. 2005-63; *Flores v. Comm'r*, T.C. Summ. Op. 2005-57.

[42] *Flores v. Comm'r*, T.C. Summ. Op. 2005-57.

as pensions, Individual Retirement Accounts (IRAs), and 401(k)s.[43] These cases presented an array of issues, including: premature distributions from a Roth IRA that exceeded contributions;[44] unpaid loans from a 401(k) account;[45] cashing out an inherited IRA;[46] and a premature distribution from an IRA.[47] The IRS won 10 of these 14 cases, taxpayers prevailed in two, and the court rendered split decisions in the two others.[48]

Two cases dealt with the 60-day rollover rule for liquidated IRAs.[49] Amounts distributed from a traditional IRA to a taxpayer are not taxable if the taxpayer puts the money into another traditional IRA within 60 days.[50] In both cases, the Tax Court applied the rule and held that the taxpayers who failed to rollover IRA distributions within 60 days must include those amounts in gross income.[51]

CONSTRUCTIVE DIVIDENDS

A constructive dividend occurs when a corporation confers an economic benefit upon a shareholder without any expectation that the shareholder will reimburse the corporation.[52] The corporation need not formally declare a dividend for a constructive dividend to exist.[53] Like a cash dividend, a constructive dividend is not deductible by the corporation and is taxable to the shareholder.[54] Constructive dividends generally occur in three ways:

- When the corporation pays the personal expenses of the shareholder;[55]

43 *Barkley v. Comm'r*, T.C. Memo. 2004-287; *Buras v. Comm'r*, T.C. Summ. Op. 2004-161; *Cohen v. Comm'r*, T.C. Memo. 2004-227; *Dirks v. Comm'r*, T.C. Memo. 2004-138; *Dotson v. Comm'r*, T.C. Summ. Op. 2004-164; *Mitchell v. Comm'r*, T.C. Summ. Op. 2004-160; *Molina v. Comm'r*, T.C. Memo. 2004-258; *Olson v. Comm'r*, T.C. Memo. 2004-197; *Peters v. Comm'r*, T.C. Summ. Op. 2005-42; *Seidel v. Comm'r*, T.C. Summ. Op. 2005-51; *Seidel v. Comm'r*, T.C. Memo. 2005-67; *Sternberg v. Comm'r*, 95 A.F.T.R.2d 402 (2d Cir. 2005); *White v. Comm'r*, T.C. Summ. Op. 2005-62; *Widemon v. Comm'r*, T.C. Memo. 2004-162.

44 *Widemon v. Comm'r*, T.C. Memo. 2004-162.

45 *White v. Comm'r*, T.C. Summ. Op. 2005-62.

46 *Olson v. Comm'r*, T.C. Memo. 2004-197.

47 *Cohen v. Comm'r*, T.C. Memo. 2004-227.

48 *Barkley v. Comm'r*, T.C. Memo. 2004-287; *Buras v. Comm'r*, T.C. Summ. Op. 2004-161; *Cohen v. Comm'r*, T.C. Memo. 2004-227; *Dirks v. Comm'r*, T.C. Memo. 2004-138; *Dotson v. Comm'r*, T.C. Summ. Op. 2004-164; *Mitchell v. Comm'r*, T.C. Summ. Op. 2004-160; *Molina v. Comm'r*, T.C. Memo. 2004-258; *Olson v. Comm'r*, T.C. Memo. 2004-197; *Peters v. Comm'r*, T.C. Summ. Op. 2005-42; *Seidel v. Comm'r*, T.C. Summ. Op. 2005-51; *Seidel v. Comm'r*, T.C. Memo. 2005-67; *Sternberg v. Comm'r*, 95 A.F.T.R.2d 402 (2d Cir. 2005); *White v. Comm'r*, T.C. Summ. Op. 2005-62; *Widemon v. Comm'r*, T.C. Memo. 2004-162.

49 *Dirks v. Comm'r*, T.C. Memo. 2004-138; *Peters v. Comm'r*, T.C. Summ. Op. 2005-42.

50 IRC § 408(d)(3)(A).

51 *Dirks v. Comm'r*, T.C. Memo. 2004-138; *Peters v. Comm'r*, T.C. Summ. Op. 2005-42.

52 *Muhich v. Comm'r*, 238 F.3d 860, 863 (7th Cir. 2001).

53 *Noble v. Comm'r*, 368 F.2d 439, 442 (9th Cir. 1966).

54 *Muhich v. Comm'r*, 238 F.3d at 863.

55 *Ali v. Comm'r*, T.C. Memo. 2004-284; *Benson v. Comm'r*, T.C. Memo. 2004-272; *Bruecher v. Comm'r*, T.C. Summ. Op. 2005-52; *Delaware Corp. v. Comm'r*, T.C. Memo. 2004-280; *Lenzen v. Comm'r*, T.C. Memo. 2005-120; *Noble v. Comm'r*, 368 F.2d 439; *Strong v. Comm'r*, T.C. Memo. 2005-125.

- When the shareholder directs one corporation to distribute assets or transfer funds to another corporation the shareholder owns;[56] and,
- When the shareholder receives money as a tax free transaction (such as a loan) from the corporation and has no intention of paying it back.[57]

Taxpayers who receive unreported income or whose personal expenses are paid by the controlled corporation sometimes claim that the payment of personal expenses is a loan to the shareholder, but courts usually reject the argument.[58]

We reviewed 12 opinions issued this year.[59] The IRS won ten cases and taxpayers prevailed twice.

UNREPORTED INCOME

We reviewed 32 cases involving unreported income this year.[60] Fifteen cases dealt with unreported business income;[61] while 14 others dealt with unreported wage and investment income reported to taxpayers and the IRS by third parties on information returns

56 *Benson v. Comm'r*, T.C. Memo. 2004-272; *Menard, Inc. v. Comm'r*, T.C. Memo. 2004-207.

57 In situations where the shareholder does not intend to pay the money back or the money is not for a tax-free transaction such as a loan. *See Bussell v. Comm'r*, T.C. Memo. 2005-77; *Gowni v. Comm'r*, T.C. Memo. 2004-154; and *Moran v. Comm'r*, T.C. Memo. 2005-66.

58 See *Bruecher v. Comm'r*, T.C. Summ. Op. 2005-52; *Gowni v. Comm'r*, T.C. Memo. 2004-154; and, *Lenzen v. Comm'r*, T.C. Memo. 2005-120. But see *Morrison v. Comm'r*, T.C. Memo. 2005-53 (company's payment of shareholder personal expenses did not constitute a constructive dividend and was a legitimate loan when the taxpayer repaid the corporation for some of the personal expenses and paid some interest on the outstanding amount).

59 *Ali v. Comm'r*, T.C. Memo. 2004-284; *Benson v. Comm'r*, T.C. Memo. 2004-272; *Bruecher v. Comm'r*, T.C. Summ. Op. 2005-52; *Bussell v. Comm'r*, T.C. Memo. 2005-77; *Delaware Corp. v. Comm'r*, T.C. Memo. 2004-280; *Gowni v. Comm'r*, T.C. Memo. 2004-154; *Lenzen v. Comm'r*, T.C. Memo. 2005-120; *Menard, Inc. v. Comm'r*, T.C. Memo. 2004-207; *Moran v. Comm'r*, T.C. Memo. 2005-66; *Morrison v. Comm'r*, T.C. Memo. 2005-53; *PK Ventures, Inc. v. Comm'r*, T.C. Memo. 2005-56; *Strong v. Comm'r*, T.C. Memo. 2005-125.

60 *Acle v. Comm'r*, T.C. Summ. Op. 2004-82; *Arvin v. Comm'r*, T.C. Summ. Op. 2004-108; *Bien-Aime v. Comm'r*, T.C. Summ. Op. 2004-175; *Blanning v. Comm'r*, T.C. Memo. 2004-201; *Brenner v. Comm'r*, T.C. Memo. 2004-202; *Castleton v. Comm'r*, T.C. Memo. 2005-58; *Chin v. Comm'r*, T.C. Memo. 2004-189; *Coccia v. Comm'r*; T.C. Summ. Op. 2004-159; *Coomes v. Comm'r*, T.C. Summ. Op. 2004-182; *Corrigan v. Comm'r*, T.C. Memo. 2005-119; *Doxtator v. Comm'r*, T.C. Memo. 2005-113; *Edwards v. Comm'r*, T.C. Memo. 2005-52; *Ford v. Comm'r*, T.C. Memo. 2005-18; *Gouveia v. Comm'r*, T.C. Memo. 2004-256; *Gowni v. Comm'r*, T.C. Memo. 2004-154; *Graham v. Comm'r*, T.C. Memo. 2005-68; *Jondahl v. Comm'r*, T.C. Memo. 2005-55; *Kikalos v. U.S.*, 408 F.3d 900 (7th Cir. 2005); *Knauss v. Comm'r*, T.C. Memo 2005-6; *Lewis v. Comm'r*, T.C. Memo. 2005-111; *Malfatti v. Comm'r*, T.C. Memo. 2005-19; *Namyst v. Comm'r*, T.C. Memo. 2004-263; *Ogu v. Comm'r*, T.C. Summ. Op. 2004-87; *Payne v. Comm'r*, T.C. Memo. 2005-130; *Pickering v. Comm'r*, T.C. Summ. Op. 2004-136; *Polonczyk v. Comm'r*, T.C. Summ. Op. 2005-66; *Rinn v. Comm'r*, T.C. Memo. 2004-256; *Rodriguez v. Comm'r*, 95 A.F.T.R.2d 1723 (9th Cir. 2005); *Rodriguez v. Comm'r*, T.C. Memo. 2005-12; *Starkovich v. Comm'r*, T.C. Summ. Op. 2004-173; *Strong v. Comm'r*, T.C. Memo. 2005-125; *Westby v. Comm'r*, T.C. Memo. 2004-179.

61 *Acle v. Comm'r*, T.C. Summ. Op. 2004-82; *Blanning v. Comm'r*, T.C. Memo. 2004-201; *Chin v. Comm'r*, T.C. Memo. 2004-189; *Coomes v. Comm'r*, T.C. Memo. 2004-182; *Edwards v. Comm'r*, T.C. Memo. 2005-52; *Gouveia v. Comm'r*, T.C. Memo. 2004-256; *Gowni v. Comm'r*, T.C. Memo. 2004-154; *Graham v. Comm'r*, T.C. Memo. 2005-68; *Kikalos v. U.S.*, 408 F.3d 900 (7th Cir. 2005); *Knauss v. Comm'r*, T.C. Memo. 2005-6; *Payne v. Comm'r*, T.C. Memo. 2005-130; *Rinn v. Comm'r*, T.C. Memo. 2004-256; *Starkovich v. Comm'r*, T.C. Summ. Op. 2004-173; *Strong v. Comm'r*, T.C. Memo. 2005-125; *Westby v. Comm'r*, T.C. Memo. 2004-179.

such as Form W-2, Form 1099-INT, Form 1099-DIV and Form 1099-MISC.[62] Three cases dealt with both kinds of unreported income.[63] Unreported business income cases often concern taxpayers receiving payments from customers and not reporting the income on their tax returns.[64] Of the 18 cases dealing with unreported business income, taxpayers won three, the IRS won 11, and four cases had split decisions in which part but not all of the IRS determination was upheld.[65] There were 17 cases in which third parties reported income on Form W-2 or Form 1099, but the taxpayer either did not file a tax return[66] or filed and did not fully report the Form W-2 or Form 1099 income.[67] The IRS won 15 cases involving unreported third party reported income, while a taxpayer won one and the final case had a split outcome.[68]

PRO SE AND REPRESENTED TAXPAYERS

Sixty of these cases, or 56 percent, were litigated without counsel, *pro se*.[69] While *pro se* litigants fared slightly better than represented litigants in cases not involving business income, represented litigants fared much better than their *pro se* counterparts in cases involving business income.

[62] *Arvin v. Comm'r*, T.C. Summ. Op. 2004-108; *Bien-Aime v. Comm'r*, T.C. Summ. Op. 2004-175; *Castleton v. Comm'r*, T.C. Memo. 2005-58; *Corrigan v. Comm'r*, T.C. Memo. 2005-119; *Doxtator v. Comm'r*, T.C. Memo. 2005-113; *Ford v. Comm'r*, T.C. Memo. 2005-18; *Lewis v. Comm'r*, T.C. Memo. 2005-111; *Malfatti v. Comm'r*, T.C. Memo. 2005-19; *Namyst v. Comm'r*, T.C. Memo. 2004-263; *Ogu v. Comm'r*, T.C. Summ. Op. 2004-87; *Pickering v. Comm'r*, T.C. Summ. Op. 2004-136; *Polonczyk v. Comm'r*, T.C. Summ. Op. 2005-66; *Rodriguez v. Comm'r*, 95 A.F.T.R.2d 1723 (9th Cir. 2005); *Rodriguez v. Comm'r*, T.C. Memo. 2005-12.

[63] *Brenner v. Comm'r*, T.C. Memo. 2004-202; *Coccia v. Comm'r*, T.C. Summ. Op. 2004-159; *Jondahl v. Comm'r*, T.C. Memo. 2005-55.

[64] *See e.g.*, *Payne v. Comm'r*, T.C. Memo. 2005-130, where the taxpayer, a roofer, deposited smaller customer payments directly into his personal bank account without reporting the payments as income.

[65] *Acle v. Comm'r*, T.C. Summ. Op. 2004-82; *Blanning v. Comm'r*, T.C. Memo. 2004-201; *Brenner v. Comm'r*, T.C. Memo. 2004-202; *Chin v. Comm'r*, T.C. Memo. 2004-189; *Coccia v. Comm'r*, T.C. Summ. Op. 2004-159; *Coomes v. Comm'r*, T.C. Memo. 2004-182; *Edwards v. Comm'r*, T.C. Memo. 2005-52; *Gouveia v. Comm'r*, T.C. Memo. 2004-256; *Gowni v. Comm'r*, T.C. Memo. 2004-154; *Graham v. Comm'r*, T.C. Memo. 2005-68; *Jondahl v. Comm'r*, T.C. Memo. 2005-55; *Kikalos v. U.S.*, 408 F.3d 900 (7th Cir. 2005); *Knauss v. Comm'r*, T.C. Memo. 2005-6; *Payne v. Comm'r*, T.C. Memo. 2005-130; *Rinn v. Comm'r*, T.C. Memo. 2004-256; *Starkovich v. Comm'r*, T.C. Summ. Op. 2004-173; *Strong v. Comm'r*, T.C. Memo. 2005-125; *Westby v. Comm'r*, T.C. Memo. 2004-179.

[66] *See e.g.*, *Malfatti v. Comm'r*, T.C. Memo. 2005-19.

[67] *See e.g.*, *Bien-Aime v. Comm'r*, T.C. Summ. Op. 2004-175.

[68] *Arvin v. Comm'r*, T.C. Summ. Op. 2004-108; *Bien-Aime v. Comm'r*, T.C. Summ. Op. 2004-175; *Brenner v. Comm'r*, T.C. Memo. 2004-202; *Castleton v. Comm'r*, T.C. Memo. 2005-58; *Coccia v. Comm'r*, T.C. Summ. Op. 2004-159; *Corrigan v. Comm'r*, T.C. Memo. 2005-119; *Doxtator v. Comm'r*, T.C. Memo. 2005-113; *Ford v. Comm'r*, T.C. Memo. 2005-18; *Jondahl v. Comm'r*, T.C. Memo. 2005-55; *Lewis v. Comm'r*, T.C. Memo. 2005-111; *Malfatti v. Comm'r*, T.C. Memo. 2005-19; *Namyst v. Comm'r*, T.C. Memo. 2004-263; *Ogu v. Comm'r*, T.C. Summ. Op. 2004-87; *Pickering v. Comm'r*, T.C. Summ. Op. 2004-136; *Polonczyk v. Comm'r*, T.C. Summ. Op. 2005-66; *Rodriguez v. Comm'r*, 95 A.F.T.R.2d 1723 (9th Cir. 2005); *Rodriguez v. Comm'r*, T.C. Memo. 2005-12.

[69] Four of the 60 cases had a split outcome and these four split outcome cases are not included in the count of *pro se* cases in Table 3.2.1.

TABLE 3.2.1, ANALYSIS OF PRO SE INCOME CASES

Type of Taxpayer	Number of Cases	*Pro Se*		*Represented*		Split Decision
		Decision for Taxpayer	Decision for IRS	Decision for Taxpayer	Decision for IRS	
Individual	83	6	41	3	27	6
Business	25[70]	1	8	6	7	3
Total	**108**	**7**	**49**	**9**	**34**	**9**

CONCLUSION

While no clear patterns emerge from the analysis of litigated cases, gross income is clearly an area of confusion and contention between taxpayers and the IRS. This year, taxpayers prevailed in whole or in part in 25 of 108 cases, or 23 percent of the total.

With the Supreme Court's ruling in *Banks* and the enactment of IRC § 62(a)(1), the area of contingent attorney's fees in litigation is clearer and likely to be litigated less often. Litigation on whether the award was received for "physical" injuries and if so, not subject to tax, continues to be an issue for the courts.

The increase in retirement and disability income cases and the variety and complexity of pension benefit tax law suggest this issue will continue to confuse taxpayers and create contention with the IRS. Other issues, such as constructive dividends and unreported income, show that some taxpayers will search out ways to avoid taxable income, and the IRS will need to be vigilant to ensure adherence to the law and proper tax collection.[71]

[70] One case involving an estate is included in the business category.

[71] Unreported income is the single largest component of the "tax gap," accounting for eighty percent of the tax gap or $251 billion to $291 billion per year. *See* Most Serious Problem*: The Cash Economy, supra*; Key Legislative Recommendation: *Measures to Reduce Noncompliance in the Cash Economy, supra.*

LITIGATED

ISSUE #3 FAILURE TO FILE PENALTY UNDER INTERNAL REVENUE CODE SECTION 6651(a)(1)

SUMMARY

The federal court system issued published decisions in 75 cases involving the penalty for failure to file a timely tax return under IRC § 6651(a)(2) during the 12 months from June 1, 2004 to May 31, 2005, which this report covers.[1] The IRS prevailed in all but five cases. The failure to file penalty is mandatory unless the taxpayer can demonstrate that the failure is due to reasonable cause and not willful neglect.[2] Among the cases analyzed, it was often very difficult for the taxpayer to meet this standard.[3]

PRESENT LAW

A taxpayer who fails to file a tax return on or before its due date will be subject to a five percent penalty for each month or partial month that the return is late.[4] This penalty generally accumulates for each month the return is not filed up to a maximum of 25 percent.[5] If the taxpayer's failure to file is fraudulent, the penalty is 15 percent per month or partial month up to a maximum of 75 percent.[6] The penalty is based on the amount of tax due, minus any credit the taxpayer is entitled to receive or payment made by the due date.[7]

The IRS has the burden of production in any court proceeding with respect to the liability of any individual for an addition to tax under IRC § 6651(a).[8] To meet this burden, the IRS must produce sufficient evidence indicating that it is appropriate to impose the relevant penalty or addition to tax.[9] Once the IRS meets this burden, the taxpayer must come forward with evidence sufficient to persuade a court that the IRS's determination is incorrect.[10] The taxpayer also bears the burden of proof with regard to issues of reasonable cause.[11] To prove reasonable cause, a taxpayer must show that he or she exercised ordinary business care and prudence, but was still unable to file by the due date.[12]

1 IRC § § 6651(a)(2) and (a)(3) also imposes failure to pay penalties as well, however, only a small number of cases involved these penalties, and therefore, the failure to pay penalty cases are not addressed here.

2 IRC § 6651(a)(1).

3 In the 2001 Annual Report to Congress, the National Taxpayer Advocate recommended a legislative change that would broaden the reasonable cause standard to include taxpayers who make one-time, inadvertent errors on their returns. National Taxpayer Advocate 2001 Annual Report to Congress 188.

4 IRC § 6651(a)(1).

5 *Id.*

6 IRC § 6651(f).

7 IRC § 6651(b).

8 IRC § 7491(c). An exception to this rule alleviates the IRS from this initial burden where the taxpayer's petition fails to state a claim for relief from the addition to tax, such as where the taxpayer only makes frivolous arguments. *Funk v. Comm'r*, 123 T.C. 213 (2004).

9 *Higbee v. Comm'r*, 116 T.C. 438, 446 (2001).

10 *Id.*

11 *Id.*

12 Treas. Reg. § 301.6651-1(c)(1).

The failure to file penalty applies to income, estate, gift, and certain excise tax returns.[13] IRC § 6698 provides for a penalty for failure to file partnership returns, which is based on different criteria but also carries a reasonable cause component.[14]

ANALYSIS OF LITIGATED CASES

We analyzed 75 opinions issued between June 1, 2004 and May 31, 2005, where the failure to file penalty was in dispute. All but seven of these cases were litigated in the United States Tax Court. A detailed listing of these cases appears in Table 3 in Appendix 3. Fifty-five cases involved individual taxpayers, 19 involved businesses (including individuals engaged in self-employment or partnerships) and one case involved an estate. Taxpayers were represented by attorneys in only 17 cases. Of the 58 cases in which taxpayers appeared *pro se*, only one case was resolved in the taxpayer's favor and one other resulted in a split decision. Thus, taxpayers were unrepresented in the vast majority of cases decided in the IRS's favor.

A common basis for the courts ruling against taxpayers in these cases was the lack of any evidence offered to show that the failure to file was due to reasonable cause.[15] The arguments taxpayers put forth in defense of their failures to file timely (or at all) include the following:

- **Medical Illness:** Depending on the facts and circumstances, a medical illness can constitute reasonable cause for failing to file a tax return on time.[16] However, courts will reject medical illness as a basis for reasonable cause where the illness did not keep the taxpayer from functioning in other aspects of life, such as work.[17] In the context of a joint return, medical conditions afflicting one spouse do not generally excuse the failure to file.[18] In one case, however, a husband's condition was severe enough to require the wife to abandon her work-related responsibilities to care for him, and impaired her ability to exercise ordinary business care and prudence.[19]

[13] IRC § 6651(a)(1).

[14] IRC § 6698.

[15] *See, e.g., Brunner v. Comm'r*, T.C. Memo. 2004-187, *Desauguste v. Comm'r*, T.C. Summ. Op. 2005-60, *Franklin v. Comm'r*, T.C. Summ. Op. 2004-126; *Greendyk v Comm'r*, T.C. Memo. 2005-108, *Malfatti v. Comm'r*, T.C. Memo. 2005-19, *Rinn v. Comm'r*, T.C. Memo. 2004-246, *Rosa v. Comm'r*, T.C. Summ. Op. 2005-53, *Widemon v. Comm'r*, T.C. 2004-162.

[16] *Harbour v. Comm'r*, T.C. Memo. 1991-532. In *Harbour*, the taxpayer was in a coma during the month before his tax return was due. Clearly, he was not able to work during this time or participate in any other life activities. Therefore, the Tax Court determined that this medical condition was a reasonable cause for failure to timely file his tax return.

[17] *O'Laughlin v. Comm'r*, T.C. Summ.Op. 2004-79 (holding that although taxpayer was in a serious automobile injury, taxpayer did not prove that the injury was severe enough to prevent taxpayer from filing her returns); *see also Barkley v. Comm'r*, T.C. Memo. 2004-287; *Appel v. Comm'r*, T.C. Summ. Op. 2004-90.

[18] *Appel v. Comm'r*, T.C. Summ. Op. 2004-90 (holding that illness of spouse was not so substantial as to prevent taxpayer from working or engaging in other activities).

[19] *Wesley v. United States*, 95 A.F.T.R.2d (RIA) 1832 (N.D. Fla. 2005).

- **Unavailability of Records:** Taxpayers also asserted the unavailability of records as a basis for the reasonable cause defense.[20] The general rule is that unavailability of records does not constitute reasonable cause.[21] If, however, the taxpayer used ordinary business care and prudence to obtain the records, the taxpayer may be able to establish reasonable cause for not timely filing.[22]
- **Reliance Upon a Tax Professional:** Some taxpayers argued that reliance upon a professional was a defense to the failure to file penalty.[23] However, the Supreme Court has made clear in *United States v. Boyle* that taxpayers have a non-delegable duty to file a return on time, and the taxpayer's reliance on an agent does not excuse failure.[24] There are exceptions to this general rule, such as where a person suffers from a disability and must rely on third parties to fulfill his or her filing obligations.[25] In one case, a U.S. district court found that reliance upon a professional, coupled with the taxpayer's illness, was reasonable cause for one tax year but not for other years in question.[26]
- **Reliance Upon Spouse or Other Agent:** The *Boyle* rule against reliance on third parties to file tax returns also applies to reliance on family members such as spouses to file, where the taxpayer knew or had reason to know that the returns were not timely filed.[27]
- **Ignorance of the Law:** Taxpayers also argued that they believed there was no obligation to file a tax return.[28] Ignorance of the law is not a reasonable cause for not timely filing, unless the taxpayer has made a reasonable good faith effort to comply with the law, or could not reasonably be expected to be aware of the requirement.[29]

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20 *Chu v. Comm'r*, T.C. Memo. 2005-110.

21 *Crocker v. Comm'r*, 92 T.C. 899, 913 (1989).

22 *Haley v. Comm'r*, T.C. Memo. 1977-348.

23 *Bruecher v. Comm'r*, T.C. Summ. Op. 2005-52 (holding belief that professional filed extension is not reasonable cause).

24 *United States v. Boyle*, 469 U.S. 241, 252(1985) (holding, "It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for a late filing under § 6651(a)(1).").

25 *Id.* at 249.

26 *Wesley v. U.S.*, 95 A.F.T.R. 2d (RIA) 1832 (N.D. Fla. 2005).

27 *Quarterman v. Comm'r*, T.C. Memo. 2004-241 (holding that reliance upon spouse does not excuse obligation to file); *Westby v. Comm'r*, T.C. Memo. 2004-179 (holding spouse knew that returns were not filed and did not take any corrective steps which were available to her).

28 *Rollins v. Comm'r*, T.C. Memo. 2004-260 (holding that taxpayer was required to file excise tax returns for IRC § 401(k) plans and taxpayer's belief that returns were not required does not constitute reasonable cause).

29 IRM § 20.1.1.3.1.2.1 provides that a taxpayer may establish reasonable cause based on ignorance of the law if: (1) a reasonable and good faith effort was made to comply with the law, or (2) the taxpayer was unaware of a requirement and could not reasonably be expected to know of the requirement.

- **"Zero Return" Filers:** Some taxpayers protested their obligation to pay taxes by filing tax returns with zeroes on every line of the tax return.[30] These taxpayers argued that they should not be assessed a failure to file penalty when a return was filed. This defense was unsuccessful as the courts hold that frivolous returns do not constitute a tax return for purposes of the IRC § 6651 penalty.

In 14 of the IRC § 6651(a)(1) cases, taxpayers asserted arguments that the courts considered frivolous.[31] In all but four of those cases, the court assessed the frivolous litigation penalty under IRC § 6673 against taxpayers.[32] The U.S. Tax Court also rendered an important decision with respect to the burden of proof in failure to file cases where the taxpayer asserts only frivolous arguments. In *Funk v. Commissioner*, the Tax Court held that while the IRS has the initial burden of production in cases involving additions to tax (such as additions under IRC § 6651), that burden is shifted if the taxpayer advances only frivolous arguments.[33]

The existence of reasonable cause in any given case depends on all the facts and circumstances of the case,[34] and what one court may find reasonable, another court may not.

CONCLUSION

The failure to file penalty was enacted to encourage voluntary compliance and make it clear that noncompliance would not be tolerated.[35] Further, the penalty seeks to establish fairness by penalizing those taxpayers who do not comply with the filing deadline. Notwithstanding that the due date for individual tax returns is common knowledge and routinely publicized by the IRS and the media, the failure to file penalty remains the subject of frequent litigation.[36]

30 *Arvin v. Comm'r*, T.C. Summ. Op. 2004-108; *Benedetti v. Comm'r*, T.C. Summ. Op. 2005-6; *Halcott v. Comm'r*, T.C. Memo. 2004-214; *Turner v. Comm'r*, T.C. Memo. 2004-251.

31 *Brenner v. Comm'r*, T.C. Memo. 2004-202; *Brunner v. Comm'r*, T.C. Memo. 2004-187; *Buras v. Comm'r*, T.C. Summ. Op. 2004-161; *Currier v. Comm'r*, T.C. Memo. 2005-21; *Florance v. Comm'r*, T.C. Memo. 2005-60; *Malfatti v. Comm'r*, T.C. Memo. 2005-19; *Milby v. Comm'r*, T.C. Memo. 2005-15; *Rodriguez v. Comm'r*, T.C. Memo. 2005-12; *Storaasli v. Comm'r*, T.C. Memo. 2005-59; *Benedetti v. Comm'r*, T.C. Summ. Op. 2005-6; *Funk v. Comm'r*, 123 T.C. 213 (2004); *Arvin v. Comm'r*, T.C. Summ. Op. 2004-108; *Greendyk v. Comm'r*, T.C. Memo. 2005-108; *Rinn v. Comm'r*, T.C. Memo. 2004-108.

32 While the courts did not assess the frivolous argument penalty in these cases, litigants were given stern warnings about advancing any such arguments in the future; *Funk v. Comm'r*, 123 T.C. 213 (2004); *Arvin v. Comm'r*, T.C. Summ. Op. 2004-108; *Greendyk v. Comm'r*, T.C. Memo. 2005-108; *Rinn v. Comm'r*, T.C. Memo. 2004-108.

33 *Funk v. Comm'r*, 123 T.C. 213 (2004).

34 IRM § 20.1.1.3.1(1).

35 *See* Policy Statement P-1-18 dated April 27, 1992, IRM 1.2.1.2.3.

> The United States tax system relies on taxpayers' willingness to voluntarily and accurately report their income, file returns, and pay taxes. Penalties encourage this type of compliance and deter noncompliance, while also attempting to establish fairness in the system by imposing an additional cost on the noncompliant taxpayer.

36 The failure to file penalty has appeared as a most litigated issue in the 2000, 2001, 2003, and 2004 Annual Report to Congress. The 2000 report groups all penalties together. The 2001 report combines the failure to file and the failure to pay penalties.

The IRS should determine whether this penalty positively influences compliance as intended. Congress should again consider the National Taxpayer Advocate's recommendation of a one-time abatement of the penalty for taxpayers who comply with their filing obligations, but in an untimely manner.[37] This proposal would broaden the definition of reasonable cause and give the IRS the authority to abate a late filing penalty for inadvertent taxpayer mistakes, while still supporting the IRS's goal of voluntary compliance.

[37] National Taxpayer Advocate 2001 Annual Report to Congress 188. This provision was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003. *See* H.R. 1528, 108th Cong. § 106 (2003).

LITIGATED ISSUE #4 TRADE OR BUSINESS EXPENSES UNDER INTERNAL REVENUE CODE SECTION 162 AND RELATED SECTIONS

SUMMARY

Trade or business expense is perennially one of the 10 most litigated tax issues in the federal courts. We identified 67 cases that included a trade or business expense issue and were litigated between June 1, 2004, and May 31, 2005. The courts affirmed the IRS position in over three-fourths of the cases, while taxpayers prevailed less than 10 percent of the time.[1] The remaining cases resulted in split decisions.

PRESENT LAW

Internal Revenue Code (IRC) section 162 is one of the Code's most fundamental provisions, allowing deductions for ordinary and necessary trade or business expenses paid or incurred during the taxable year. Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance. The IRS, Department of Treasury, Congress, and the courts continue to 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 judicial review of the IRS's determination of tax liability, the courts must often address a series of questions, including those discussed below, before issuing decisions.

What constitutes a trade or business for purposes of IRC § 162?

Although "trade or business" is one of the most widely used terms in the IRC, neither the Code nor the Treasury Regulations provide a definition.[2] The definition of "trade or business" comes from the common law of federal income tax, where concepts have been developed and refined by court decisions.[3] The Supreme Court has interpreted "trade or business" for purposes of IRC § 162 to mean an activity conducted "with continuity and regularity" and with the primary purpose of making income or a profit.[4]

What is an ordinary and necessary expense?

Ordinary and necessary expenses are current business expenses that are paid or incurred during the taxable year. A current business expense must be both ordinary and necessary in relation to the taxpayer's trade or business.[5] In *Welch v. Helvering*,[6] the Supreme Court stated that the words "ordinary" and "necessary" have difference in meaning, and both

1 The IRS prevailed in 51 of 67 cases, while taxpayers prevailed in six cases.

2 In 1986, the term "trade or business" appeared in at least 492 subsections of the Code and 664 provisions of the Treasury Regulations. F. Ladson Boyle, *What Is a Trade or Business?* 39 Tax Law. 737 (Summer 1986).

3 Carol Duane Olson, *Toward a Neutral Definition of "Trade or Business" in the Internal Revenue Code*, 54 U. Cin. L. Rev. 1199 (1986).

4 *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987).

5 IRC § 162(a).

6 290 U.S. 111 (1933).

must be satisfied for a taxpayer to benefit from the deduction. In *Deputy v. Du Pont*,[7] the Supreme Court described an "ordinary" expense as customary or usual and of common occurrence in the taxpayer's business. A "necessary" expense is described as appropriate and helpful for development of the business.[8]

The courts have held that the amount of the expense must be reasonable as well as ordinary and necessary. In *Commissioner v. Lincoln Elec. Co.*,[9] the Court of Appeals for the Sixth Circuit held that "…the element of reasonableness is inherent in the phrase 'ordinary and necessary.' Clearly, it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount."[10]

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, including adequate records to substantiate deductions claimed as trade or business expenses.[11] If a taxpayer is unable to substantiate deductions by documentary evidence (e.g., invoice, paid bill, or canceled check) but can establish that he or she had some deductible business expenditures, the courts may opt to employ the *Cohan* rule to grant the taxpayer a reasonable amount of deductions.

The *Cohan* rule is a rule of "indulgence" established by the Court of Appeals for the Second Circuit in its decision in *Cohan v. Commissioner*.[12] 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."[13]

The *Cohan* rule may not be utilized in situations where IRC § 274(d) applies. Code section 274(d) provides that unless a taxpayer complies with strict substantiation rules, no deduction is allowable for (1) traveling expenses, (2) entertainment expenses, (3) gifts, or (4) certain "listed property."[14] A taxpayer is required to substantiate a claimed IRC § 274(d) expense with adequate records or sufficient evidence corroborating the taxpayer's statement establishing the amount, time, place, and business purpose of the expense.[15]

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[7] 308 U.S. 488, 495 (1940).

[8] *Comm'r v. Tellier*, 383 U.S. 687, 679 (1996) (citations omitted).

[9] 176 F.2d 815 (6th Cir. 1949).

[10] *Comm'r v. Lincoln Elec. Co.*, 176 F.2d 815, 817 (6th Cir. 1949) (citation omitted).

[11] IRC § 6001; Treas. Reg. § 1.6001-1; Treas. Reg. § 1.446-1(a)(4).

[12] 39 F.2d 540 (2nd Cir. 1930).

[13] *Cohan v. Comm'r*, 39 F.2d 540, 544 (2nd Cir. 1930).

[14] "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, etc. IRC § 280F(d)(4)(A)(ii), (iii), and (iv).

[15] Treas. Reg. § 1.274-5T(b).

Who has the burden of proof in a substantiation case?

Generally, a taxpayer bears the burden of proving entitlement to the business expense deductions and that the proposed determination made by the Commissioner of Internal Revenue is incorrect.[16] IRC § 7491(a) provides that the burden of proof shifts to the Commissioner under certain specified conditions.[17]

In order to shift the burden to the Commissioner, a taxpayer must: (1) introduce credible evidence with respect to any factual issue relevant to ascertaining the taxpayer's liability; (2) comply with the requirements to substantiate deductions; (3) maintain all records required under the IRC; and (4) cooperate with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.[18]

ANALYSIS OF LITIGATED CASES

Trade or business expenses have been one of the 10 most litigated issues by taxpayers since the first edition of the National Taxpayer Advocate's Annual Report to Congress in 1998.[19] We reviewed 67 cases involving various trade or business expense issues that were litigated in the federal court system during the period June 1, 2004, through May 31, 2005. Table 4 in Appendix 3 contains a detailed listing of the cases.

Table 3.4.1 categorizes the significant trade or business expense issues raised by taxpayers. Cases involving multiple issues are included in more than one category. In *Doxtator v. Commissioner*,[20] for example, three distinct trade or business expense issues were raised, so the case can be found in three categories in Table 3.4.1.

[16] *See* Tax Court Rule 142(a) and *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

[17] IRC § 7491(a)(1) applies to a court proceeding in which the examination started after July 22, 1998, and if there is no examination, to the taxable period or events which started or occurred after July 22, 1998.

[18] IRC § 7491(a)(1), (2).

[19] National Taxpayer Advocate 1998-2004 Annual Report to Congress.

[20] T.C. Memo. 2005-113.

TABLE 3.4.1, TRADE OR BUSINESS EXPENSE CASES & ISSUES

Issue	Type of Taxpayer	
	Sole Proprietor	Business Entity
Ordinary and Necessary Trade or Business Expenses[21]	44	12
Casualty Loss[22]	5	2
Depreciation[23]	6	1
Expense Election under IRC § 179[24]	1	1
Profit Objective[25]	10	0
Substantiation of Expenses[26]	25	2
Material Participation in Passive Activity[27]	1	0

TABLE 3.4.2, PREVAILING PARTY IN TRADE OR BUSINESS EXPENSE COURT DECISIONS, PRO SE TAXPAYER VERSUS TAXPAYERS WITH REPRESENTATION

Type Of Taxpayer	IRS	Taxpayer	Split	Total
Pro Se	39	2	5	46
Represented by Counsel	12	4	5	21
Totals	**51**	**6**	**10**	**67**

Over two-thirds of the taxpayers litigating trade or business issues represented themselves *pro se*. Table 3.4.2 shows that represented taxpayers fared better than their *pro se* counterparts. Taxpayers with representation received full or partial relief in 43 percent of the cases litigated (nine of 21), while *pro se* taxpayers received relief only 15 percent of the time (seven of 46).

[21] IRC § 162(a) allows deductions for ordinary and necessary trade or business expenses paid or incurred during the taxable year.

[22] IRC § 165(a) allows a deduction for any loss sustained during the taxable year that is not compensated for by insurance or otherwise.

[23] IRC § 167(a) provides for a depreciation deduction for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business or held for the production of income.

[24] Under IRC § 179, a taxpayer may make an election to expense certain depreciable business assets.

[25] IRC § 183(a) provides that no deduction attributable to an activity shall be allowed if such activity is not engaged in for profit.

[26] IRC § 6001 requires a taxpayer to maintain books and records that substantiate income, deductions, and credits, including adequate records to substantiate deductions claimed as trade or business expenses. For certain expenses, IRC 274(d) requires taxpayers substantiate by adequate records (1) the amount of such expense or other item; (2) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift; (3) the business purpose of the expense or other item; and (4) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift.

[27] IRC § 469 disallows a deduction for taxpayers engaged in a "passive activity" unless the taxpayer materially participates in that activity. IRC § 469(c)(2) includes any rental activity in the definition of "passive activity."

COURT DECISIONS

Table 3.4.3 reflects the disposition of court decisions in each category of cases.

TABLE 3.4.3, PREVAILING PARTY IN TRADE OR BUSINESS EXPENSE COURT DECISIONS, SOLE PROPRIETORS VERSUS BUSINESS ENTITIES

Type Of Taxpayer	IRS	Taxpayer	Split	Total
Sole Proprietors	42	3	7	52
Business Entities	9	3	3	15
Totals	**51**	**6**	**10**	**67**

Sole Proprietors

Fifty-two of the 67 cases analyzed were litigated by taxpayers in their capacity as sole proprietors. In many instances, sole proprietors claimed trade or business deductions without adequately documenting those expenses with contemporaneous record-keeping.

For example, in *Blanning v. Commissioner*,[28] a taxpayer who was convicted of illegal business practices failed to file federal tax returns for the years in question. The IRS denied trade or business expense deductions for those years, as the taxpayer could not provide records of expenses. Generally, a taxpayer must show that he or she is entitled to deductions with respect to business activity. Taxpayers are required to maintain books and records in support of the items reported on a return. In this case, the *pro se* taxpayer attempted to meet his burden by reconstructing his expenditures through secondary and incomplete documentation, such as credit card statements. The Tax Court held that under the *Cohan* rule, inadequately substantiated expenses may be estimated where it is shown that a taxpayer is unquestionably entitled to some deductions. Accordingly, the court held that the taxpayer was entitled to business deductions of $15,123 and $5,492 for the years in question.

Another common trade or business issue litigated by sole proprietors relates to whether an activity had a profit objective. To be considered a bona fide trade or business, an activity must be conducted with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity must be for income or profit. The test for whether a taxpayer conducted an activity for profit is whether he or she entered into or continued the activity with an actual or honest objective of making a profit.[29]

In *Lopez v. Commissioner*,[30] the *pro se* taxpayers appealed the Tax Court's determination that the taxpayers did not have a sufficient profit motive in their Amway activities to be entitled to trade or business expense deductions. The taxpayers were distributors for

[28] T.C. Memo. 2004-2001.

[29] IRC § 183; Treas. Reg. § 1.183-2(a).

[30] 94 A.F.T.R.2d (RIA) 7075 (5th Cir. 2004).

Amway, a marketer of various personal and household products. In their Amway activities, the taxpayers sold products at cost to both their downline distributors and their customers, many of whom were friends of the taxpayers. Although the taxpayers had no prior business experience, they did not seek advice from unbiased, independent business sources. The Court of Appeals for the Fifth Circuit affirmed the Tax Court's decision, noting that the taxpayers spent much of their Amway-related time socializing with the family and friends they had recruited as downline distributors.

Business Entities

Fifteen of the 67 trade or business expense cases tried in federal courts involved business entities, which had slightly greater success than sole proprietors in receiving a favorable outcome. Taxpayers received full or partial relief from the courts in 40 percent of the business entity cases (six of 15), compared to less than 20 percent in sole proprietor cases (10 of 52). This success rate may be explained in part by the fact that most business entities were represented in court by attorneys, whereas most sole proprietors represented themselves.

Congress enacted IRC § 179 to provide an incentive for businesses to invest in new tangible personal property. Section 179(a) allows a business a deduction for property used in a trade or business that it must otherwise add to its capital account and depreciate. However, certain kinds of property are excluded from the definition of "section 179 property," including "property which is used predominantly to furnish lodging or in connection with the furnishing of lodging."[31] An exception to the exclusion is "property used by a hotel or motel in connection with the trade or business of furnishing lodging where the predominant portion of the accommodations is used by transients."[32]

In *Shirley v. Commissioner*,[33] the Tax Court considered whether a taxpayer in the business of renting and selling motor homes qualified for the § 179 deduction for the cost of a motor home. The IRS argued that motor homes generally are property used predominantly to furnish lodging. The taxpayer contended that motor homes are primarily for transportation. In the alternative, the taxpayer also argued that even if a motor home is predominantly used for lodging, it qualifies for the exception to the exclusion because it is lodging used by transients, and most of the taxpayer's customers were short-term renters (less than 30 days). The Tax Court, while recognizing the difficulty in making an "all or nothing" classification of mixed-use assets, concluded that the purchase of a motor home rented primarily to transients qualified for the deduction under § 179.

[31] *See* IRC § 179(d)(1); IRC § 50(b)(2).

[32] IRC § 50(b)(2)(B).

[33] T.C. Memo 2004-188.

CONCLUSION

Taxpayers continue to challenge the IRS with regard to trade or business expense deductions, and represented taxpayers fare better than their *pro se* counterparts. While the IRS generally prevails, the courts do not always favor the IRS's application of the law to the taxpayer's facts and circumstances. This is an indication that the definition of an allowable trade or business expense is open to interpretation.

Many of the cases analyzed demonstrate taxpayer confusion over legal requirements. The IRS can assist these taxpayers and minimize litigation by continuing to provide clear guidance on the deductibility of trade or business expenses. Through education, outreach, and partnering with stakeholders, the IRS can help taxpayers understand what trade or business deductions are allowable and how to substantiate those expenses. The IRS should continue to reach out proactively to taxpayers about this issue, particularly sole proprietors. By helping them understand the legal requirements, the IRS will encourage taxpayers to comply with their tax obligations and minimize the risk of litigation.

LITIGATED

ISSUE #5 FRIVOLOUS ISSUES PENALTY UNDER INTERNAL REVENUE CODE SECTION 6673

SUMMARY

During the 12 months between June 1, 2004, and May 31, 2005, the federal court system issued decisions in at least 67 cases involving the IRC § 6673 penalty. This penalty is assessed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, or unreasonably failing to pursue administrative remedies.[1] In 18 of these cases, the United States Tax Court decided not to impose the penalty but did warn taxpayers that sanctions may be appropriate in the future if they engaged in similar conduct.[2] Nonetheless, we include these cases in our analysis to help illustrate what conduct the courts will and will not tolerate.

PRESENT LAW

The United States Tax Court is authorized to impose a penalty against a taxpayer if he or she institutes or maintains a proceeding primarily for delay, takes a frivolous position in a proceeding, or unreasonably fails to pursue available administrative remedies.[3] The maximum penalty is $25,000.[4] In some cases, the IRS requests that the Tax Court impose the penalty; in other cases, however, the Tax Court may exercise its discretion *sua sponte*,[5] in imposing the penalty.

Any attorney or other person admitted to practice before the Tax Court who unreasonably and vexatiously multiplies the proceedings in any case could have to personally pay the excess costs, expenses, and attorneys' fees incurred because of such conduct.[6]

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[1] IRC § 6673(a)(1).

[2] *Arevalo v. Comm'r*, 124 T.C. 244 (2005); *Arvin v. Comm'r*, T.C. Summ. Op. 2004-108; *Cozzens v. Comm'r*, T.C. Memo. 2005-98; *Dalton v. Comm'r*, T.C. Memo. 2005-7; *Dashiell v. Comm'r*, T.C. Memo. 2004-210; *Dues v. Comm'r*, T.C. Memo. 2005-109; *Funk v. Comm'r*, 123 T.C. 213 (2004); *Greendyk v. Comm'r*, T.C. Memo. 2005-108; *Mathews v. Comm'r*, T.C. Memo. 2005-84; *McBride v. Comm'r*, T.C. Memo 2004-178; *Olson v. Comm'r*, T.C. Memo. 2004-234; *Rewerts v. Comm'r*, T.C. Memo. 2004-248; *Rinn v. Comm'r*, T.C. Memo. 2004-246; *Sides v. Comm'r*, T.C. Memo. 2004-141; *Shireman v. Comm'r*, T.C. Memo. 2004-155; *Smith v. Comm'r*, T.C. Memo. 2004-198; *Snyder v. Comm'r*, T.C. Memo. 2005-89; *Thompson v. Comm'r*, T.C. Memo. 2004-204. In each of these cases, the taxpayers were spared the IRC § 6673 penalty by the Tax Court's good graces.

[3] IRC § 6673(a)(1)(A),(B),(C).

[4] IRC § 6673(a)(1).

[5] "Sua sponte" is a term that means without prompting or suggestion. Thus, for conduct that the Tax Court finds particularly offensive, the Tax Court can choose to impose a penalty under IRC § 6673 even if the IRS has not requested that the penalty be imposed. *See, e.g., Brunner v. Comm'r*, T.C. Memo. 2004-187 (Tax Court imposed the penalty without being asked to do so when the taxpayer made numerous frivolous constitutional arguments regarding the requirement to file an income tax return).

[6] IRC § 6673(a)(2).

Taxpayers who institute an action pursuant to IRC § 7433[7] in a United States district court for damages against the United States could be subject to a maximum penalty of $10,000 if the court determines that the taxpayer's position in the proceedings is frivolous or groundless.[8] In addition, federal laws and rules of procedure permit other federal courts to apply penalties for raising frivolous arguments or using litigation tactics only to delay the collection process.[9] However, this report covers only IRC § 6673 due to the number of cases involving this Code section.

ANALYSIS OF LITIGATED CASES

We analyzed 67 opinions issued between June 1, 2004 and May 31, 2005 that addressed the IRC § 6673 penalty. All but ten of these cases were decided in the United States Tax Court.[10] A detailed listing of these cases appears in Table 5 in Appendix 3. Sixty-four of these cases involved individual taxpayers and the other three involved business taxpayers. Only three taxpayers were represented by attorneys. Taxpayers appeared *pro se* in the remaining 64 cases. Taxpayers were spared the penalty in 18 cases. Therefore, taxpayers were unrepresented in nearly all cases, and a majority of the cases were decided in the IRS's favor.

Taxpayers repeatedly raised the following arguments that the Tax Court has deemed frivolous and groundless, and consequently were subject to a penalty under IRC § 6673(a)(1):

- **Invalid notice of deficiency:** Taxpayers argued that a notice of deficiency was invalid because the person sending it lacked sufficient authority to sign the notice. For instance, in one case a taxpayer argued that the notice was invalid because it was not signed by the Secretary of the Treasury, and his request for a delegation order was not met.[11] In rejecting the taxpayer's argument, the Tax Court explained that the Secretary's authority to issue a notice of deficiency was delegated to IRS service

[7] IRC § 7433(a) allows taxpayers a cause of action against the IRS, as follows:

> If, in connection with any collection of Federal tax with respect to a taxpayer, any officer or employee of the Internal Revenue Service recklessly or intentionally, or by reason of negligence, disregards any provision of this title, or any regulation promulgated under this title, such taxpayer may bring a civil action for damages against the United States in a district court of the United States. Except as provided in section 7432, such civil action shall be the exclusive remedy for recovering damages resulting from such actions.

[8] IRC § 6673(b)(1).

[9] 28 U.S.C.A § 1927 (providing Federal courts can sanction an attorney or any other person admitted to practice before any court of the United States or any Territory thereof for unreasonably and vexatiously multiplying proceedings).

[10] In nine cases, the Tax Court awarded a penalty under IRC § 6673(a)(1) and the taxpayers appealed to the applicable United States Court of Appeals. The judgment of the Tax Court regarding the penalty was affirmed in each of those cases. We also identified one case involving IRC § 6673(b)(1), where the taxpayers instituted an action under IRC § 7433. *See Mathis v. U.S.*, 94 A.F.T.R.2d (RIA) 6340 (D. S.D. 2004) (court required taxpayers to pay a penalty of $3,000 under IRC § 6673(b)(1) because taxpayers knew at the time they instituted their action that their claims had been rejected in previous cases).

[11] Henderson v. Comm'r, T.C. Memo. 2004-157 (holding that the Memphis Service Center Director had the authority to sign the notice of deficiency; therefore, taxpayer failed to raise any legitimate arguments and the proceeding was instituted and maintained primarily for delay). Compare Thompson v. Comm'r, T.C. Memo. 2004-204 (Tax Court declined to impose the penalty even though the taxpayer argued the notice of deficiency was invalid because it wasn't signed by the Secretary or his delegate).

center directors, and the Code does not require the IRS to provide the taxpayer with a copy of the delegation order.[12] In a different case, a taxpayer attempted to argue that he did not receive a notice of deficiency. In rejecting the taxpayer's argument, the Tax Court relied on the testimony given at trial to conclude that the taxpayer may have intentionally provided the IRS with the wrong mailing address.[13] Moreover, the Tax Court noted that the taxpayer ignored the Court's explicit previous warning that any further proceedings would be subject to an IRC § 6673 penalty if frivolous issues were raised.[14] Contrast these cases with *Rewerts v. Commissioner*, T.C. Memo. 2004-248, in which the Tax Court declined to impose the penalty when the taxpayer argued the notice of deficiency was invalid. In its analysis, the Tax Court noted that there was no evidence the taxpayer had previously been a litigant in the Tax Court, and no evidence the taxpayer had been given a warning of the possible imposition of the penalty if he continued making his arguments.

- **Income is not taxable:** In one case, a taxpayer argued that he should not be subject to an income tax because he was a minister and his income was remuneration directly to his church to be used for charitable purposes. The taxpayer also contended his pension plan payments and Social Security payments were exempt from federal income tax because he donated the majority of his income to his church and was an agent of the tax exempt religious order.[15] In rejecting the taxpayer's arguments, the Tax Court noted that the taxpayer did not receive the pension or social security benefits in his capacity as a minister, but rather received them from his former job with the motion picture industry. Moreover, the taxpayer paid rent and other expenses before distributing the remainder of his income to the church. Therefore, the taxpayer was not relieved of his obligation to pay federal income tax and did not enjoy the same tax-exempt status as the church.[16]
- **IRS failed to notify taxpayer of its authority to collect taxes provided in the Internal Revenue Code:** Taxpayers also asserted the frivolous argument that the IRS had no authority to collect income tax.[17] In rejecting the taxpayers' arguments, the Tax Court emphasized that it has consistently imposed § 6673 penalties in lien and levy cases where the taxpayer raised frivolous arguments as to the validity of the Federal income tax.

[12] *Henderson v. Comm'r*, T.C. Memo. 2004-157.

[13] *Lehmann v. Comm'r*, T.C. Memo. 2005-90 (holding that the taxpayer cannot deliberately refuse the delivery of a statutory notice and then claim to have defeated actual receipt, and therefore, the taxpayer's failure to inform the IRS of his new address was a frivolous argument).

[14] *Id.*

[15] *Buras v. Comm'r*, T.C. Summ. Op. 2004-161. For more discussion of common taxpayer arguments regarding whether wages are taxable, see *Howard v. Comm'r*, T.C. Memo. 2005-144; *Krueger v.Comm'r*, T.C. Memo. 2005-105; *Howard v. Comm'r*, T.C. Memo. 2005-100. In each of these cases, the arguments were rejected as frivolous and without merit and the Tax Court imposed a penalty.

[16] *Id.*

[17] *Kolker v. Comm'r*, T.C. Memo. 2004-288; *Gilligan v. Comm'r*, T.C. Memo. 2004-194; *Gavigan v. Comm'r*, T.C. Summ. Op. 2004-155.

- **Raising frivolous issues in Collection Due Process hearings for the purpose of delay:** The taxpayer always has a right to a Collection Due Process hearing with the IRS Appeals function when the IRS is proposing its first levy action or after it files a notice of federal tax lien with respect to any tax periods.[18] Taxpayers must be informed in writing of their right to a hearing. Some taxpayers abuse this right to a hearing to delay the collection process.[19] During the hearings, when the taxpayer continues to raise frivolous arguments, Appeals officers provide the taxpayer with a copy of cases that illustrate the consequence (i.e., the IRC § 6673 penalty) for raising such frivolous issues.[20] Moreover, in many of these lien and levy cases, the Tax Court gave explicit warning regarding the possibility of a sanction under IRC § 6673 but taxpayers nonetheless continued making frivolous arguments in further proceedings.[21]

In only one case in our review did the taxpayer ask the Tax Court to sanction the IRS's attorney.[22] In concluding that the taxpayer's motion for sanctions was without merit, the Tax Court found that the taxpayer had been uncooperative and strongly cautioned the taxpayer against proceeding in bad faith in future Tax Court litigation.[23]

CONCLUSION

Taxpayers did not raise any genuine issues in the cases we analyzed. These taxpayers raised frivolous arguments, which have been repeatedly litigated and rejected in the past. The courts have consistently stated that these boilerplate arguments are frivolous and without merit. These cases best serve as a warning to taxpayers and their representatives – the IRS will ask the Tax Court to impose the IRC § 6673 penalty on taxpayers who raise frivolous or groundless issues or institute proceedings for the purpose of delay. Moreover, even if the IRS does not request a penalty, taxpayers may not escape sanctions if the Tax Court finds their conduct to fall within the activities Congress made subject to IRC § 6673.

18 IRC §§ 6320 and 6330.

19 *Williams v. Comm'r*, T.C. Memo. 2005-94 (holding that taxpayers who abuse the protections provided to them under IRC § 6330 by bringing dilatory or frivolous actions will be subject to a penalty under IRC § 6673).

20 *Poe v. Comm'r*, T.C. Memo. 2005-107. In that case, the Tax Court quoted from language in the attachment to the notice of determination where the taxpayer was clearly warned about the possibility of a penalty. In addition, IRS provided taxpayer with a copy of prior cases where the same arguments had been deemed frivolous.

21 See *Burke v. Comm'r*, 124 T.C. 189 (2005) (penalty of $2500 awarded when taxpayer did not raise any legitimate issues at trial and frivolous issues that had previously been addressed by the Tax Court in taxpayer's earlier proceeding for other tax years were perpetrated).

22 *Casey v. Comm'r*, T.C. Memo. 2004-288.

23 *Id.*

LITIGATED

ISSUE #6 NEGLIGENCE PENALTY UNDER INTERNAL REVENUE CODE SECTION 6662(b)(1)

SUMMARY

We reviewed 57 cases involving the accuracy related penalty under Internal Revenue Code section 6662(b)(1) issued by federal courts during the 12 months from June 1, 2004 to May 31, 2005.[1] This penalty is assessed against taxpayers for underpayment of tax due to the taxpayer's negligence or disregard of tax rules or regulations and was generally decided in conjunction with other issues in the cases analyzed. While IRC § 6662 provides an accuracy-related penalty for other conduct as well,[2] this report covers only the negligence penalty because of the number of cases litigated on this issue. Taxpayers can avoid the accuracy-related penalty only if they are able to demonstrate that the negligence was due to "reasonable cause" and that they "acted in good faith."[3] As the cases analyzed here indicate, it is often difficult for the taxpayer to satisfy the reasonable cause and good faith standard.

PRESENT LAW

The federal income tax system relies on the willingness of taxpayers to voluntarily and accurately report their income, file returns, and pay taxes. Civil penalties have been incorporated into the system to encourage voluntary compliance and deter noncompliance. The assessment of penalties can also promote fairness by subjecting noncompliant taxpayers to an additional cost.[4]

Underpayment of taxes occasioned by taxpayers' negligence or disregard of the rules and regulations will generally be subject to a 20 percent penalty of the underpaid tax.[5] For purposes of this provision, the term "negligence" means any failure to make a reasonable attempt to comply with the Internal Revenue Code and the term "disregard" includes careless, reckless or intentional disregard of the law.[6] The 20 percent penalty for negligence will be applied when a taxpayer fails to:

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1 These cases are identified by researching opinions published through online legal research services.

2 IRC § 6662(b) sets forth the causes for underpayments of tax for which the accuracy-related penalty can be assessed;
(b) Portion of underpayment to which section applies. This section shall apply to the portion of any underpayment which is attributable to one or more of the following:
(1) Negligence or disregard of rules or regulations.
(2) Any substantial understatement of income tax.
(3) Any substantial valuation misstatement under chapter 1.
(4) Any substantial overstatement of pension liabilities.
(5) Any substantial estate or gift tax valuation understatement.

3 IRC § 6664(c).

4 Policy Statement P-1-18, dated April 27, 1992, IRM § 1.2.1.2.3.

5 IRC § 6662(a). Additionally, taxpayers will be subjected to a 40 percent penalty if an underpayment for a taxable year is attributable to a substantial valuation overstatement. IRC § 6662(e).

6 IRC § 6662(c); *see also* Treas. Reg. § 1.6662-3(b)(1), (2).

- Make a reasonable attempt to comply with the tax code;
- Exercise ordinary and reasonable care when preparing a tax return;
- Keep adequate books and records; and
- Substantiate items properly.[7]

The IRS has identified other indicators of negligence, including:

- Failure to report income included on an information return;[8]
- Failure to make a reasonable inquiry into the correctness of a deduction, credit, or exclusion on the tax return that seems too good to be true under the circumstances;[9] and
- Items on individual returns of partners or S corporation shareholders that are clearly inconsistent with the treatment of those items on the returns of the partnership or S Corporation.[10]

The Internal Revenue Manual also provides guidelines for IRS examiners to consider when assessing the negligence penalty.[11]

The IRS bears the burden of production in court with regard to whether the negligence penalty is appropriate.[12] The burden of production requires the IRS to come forward with sufficient evidence to indicate that it is appropriate to impose the penalty.[13] Once the IRS meets this burden, the penalty is mandatory unless the taxpayer can demonstrate that he or she acted with reasonable cause and in good faith. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all the pertinent facts and circumstances.[14]

To prove reasonable cause and good faith, taxpayers must primarily show that they made a reasonable attempt to assess their correct tax liabilities, and that any error was the result of an honest misunderstanding of fact or law that is reasonable considering all facts and circumstances.[15] When analyzing the circumstances of the case, the courts can consider the taxpayer's experience, knowledge, and education level.[16]

7 Treas. Reg. § 1.6662-3(b)(1).

8 Treas. Reg. § 1.6662-3(b)(1)(i).

9 Treas. Reg. § 1.6662-3(b)(1)(ii).

10 Treas. Reg. § 1.6662-3(b)(1)(iii) and (iv).

11 IRM 20.1.5.7.1(3) provides that the following are indicators of negligence:
Unreported or understated income; significantly overstated deductions or credits; careless, improper, or exaggerated deduction; misrepresenting or miscategorizing deductions in such a way as to conceal their true nature; unexplainable items; inadequately kept books or 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 (*e.g.*, Earned Income Tax Credit) that had been adjusted in a prior year; and providing one's return preparer with incorrect or incomplete information.

12 IRC § 7491(c).

13 *Id.*

14 Treas. Reg. § 1.6664-4(b)(1).

15 *Id.*

16 *Id.*

ANALYSIS OF LITIGATED CASES

Of the 57 published opinions reviewed, 17 cases involved individual income taxpayers and 40 involved business taxpayers. The accuracy-related penalty was not the primary issue in the majority of the cases analyzed, but was considered in conjunction with underlying tax deficiencies. The IRS prevailed in 39 cases (68 percent), while taxpayers prevailed in 13 cases (23 percent), and five cases ended in split decisions. Taxpayers were represented by counsel in 24 cases and were *pro se* in the 33 others. A detailed listing of these cases appears in Table 6 in Appendix 3.

A common reason for courts ruling against taxpayers was the lack of any evidence offered by taxpayers to demonstrate that there was reasonable cause and that the taxpayers acted in good faith with respect to the underpayments of tax.[17] In other cases, taxpayers advanced cogent explanations, but had varying degrees of success, as demonstrated by a summary of the arguments set out below:

- **Taxpayer Did Not Receive Information Returns:** This argument is rarely successful in defeating the IRC § 6662(b)(1) penalty because there are other methods taxpayers could use to compute their income, and the burden of reporting the proper amounts of income and paying the proper amount of tax is not contingent upon a third party supplying information returns. Moreover, the IRS views the failure to include on an income tax return an amount of income shown on an information return as a strong indication of negligence.[18] If, however, taxpayers do not receive an information return, such as a Form W-2 (*Wage and Tax Statement*), but nonetheless still attempt to comply with the tax laws, then they may be able to demonstrate reasonable cause and avoid the accuracy-related penalty.[19]
- **Information Provided on Information Return Was Incorrect:** One taxpayer asserted the reasonable cause defense based on reliance on inaccurate information on a Form W-2 Wage and Tax Statement, which failed to include the taxpayer's bonus amount. The Tax Court upheld the negligence penalty on the basis that the taxpayer failed to make a reasonable attempt to comply with the provisions of the Internal Revenue Code.[20] The taxpayer appealed, and the Tenth Circuit Court of Appeals determined that the Tax Court's conclusion as to the reasonableness of the taxpayer's conduct was not erroneous and affirmed the penalties.[21]
- **Unsubstantiated Arguments by Taxpayers:** A number of taxpayers tried to make the argument that the positions taken on their returns were reasonable, however,

[17] *Rahimi v. Comm'r*, T.C. Summ. Op. 2004-156 (holding that there was nothing in the record indicating that the taxpayers acted with reasonable cause); *Montagne v. Comm'r*, T.C. Memo. 2004-252.

[18] Treas. Reg. § 1.6662-3(b)(i).

[19] *Namyst v. Comm'r*, T.C. Memo. 2004-263 (holding that taxpayers must make an effort to comply with the tax law based on the information that they have).

[20] *Williams v. Comm'r*, T.C. Memo. 2003-97.

[21] *Williams v. Comm'r*, 95 A.F.T.R. 2d (RIA) 764 (10th Cir. 2005)(taxpayer's employer later issued corrected W-2s to taxpayer but taxpayer made no effort to file amended returns for the years in question).

they failed to provide any documentation to substantiate their claims.[22] Maintaining accurate and complete books and records is crucial because it demonstrates that taxpayers are trying to be responsible, notwithstanding the fact that unintentional errors were committed.

- **Reliance on a Tax Professional:** Reliance on a tax professional is a defense to the negligence penalty if the reliance is reasonable based upon all of the facts and circumstances of the taxpayer's situation.[23] This defense was a recurring issue in the cases reviewed, and a number of taxpayers prevailed against the IRS by making the necessary showing of proof that:
  - The tax adviser was a competent professional who had sufficient expertise to justify reliance;
  - The taxpayer provided all necessary information to the preparer; and
  - The taxpayer relied in good faith on the adviser's judgment.[24]

  Taxpayers were not granted relief from the penalty where:
  - The taxpayer did not review the tax return before signing ;[25]
  - Reliance on tax professional was not reasonable;[26] and
  - The taxpayer did not provide the tax professional with accurate and complete information.[27]

22 *Dumond v. Comm'r*, T.C. Summ.Op. 2005-11 (holding that taxpayer could not substantiate deductions reported on Schedule C); *Biazar v. Comm'r*, T.C. Memo. 2004-270 (taxpayers failed to establish reasonable cause or good faith in failing to maintain records for Schedule C expenses); *Starkovich v. Comm'r*, T.C. Summ. Op. 2004-173 (taxpayer failed to keep adequate books and records).

23 Treas. Reg. § 1.6664-4(c).

24 *Caspian Consulting Group, Inc. v. Comm'r*, T.C. Memo. 2005-54; *Bernardo v. Comm'r*, T.C. Memo. 2004-199. *Compare Mediaworks, Inc. v. Comm'r*, T.C. Memo. 2004-177 (citations omitted) (concluding that none of the three requirements were met: (1) the mere fact that someone is a certified public accountant does not make him a competent advisor; (2) taxpayer didn't provide advisor with all necessary information and actually gave advisor misinformation; and (3) taxpayer did not rely in good faith on advisor's judgment when taxpayer had the same deduction disallowed in an earlier year).

25 *Bien-Aime v. Comm'r*, T.C. Memo. 2004-281 (failure to carefully review return before signing is not reasonable). *See also McNair v. Comm'r*, T.C. Summ. Op. 2004-115.

26 *Kooyers v. Comm'r*, T.C. Memo. 2004-281 (holding that relying on tax professional was unreasonable when the tax scheme was without economic substance has repeatedly been rejected by courts and taxpayers offered no evidence that adviser was competent); *Van Scoten v. Comm'r*, T.C. Memo. 2004-275 (reliance on another investor in the same partnership was unreasonable); *Hansen v. Comm'r*, T.C. Memo. 2004-269 (advice from general partner or partner's counsel was not reasonable, as such advice was not free from an inherent conflict of interest); *Barnes v. Comm'r*, T.C. Memo. 2004-266 (involving IRC § 6653, the predecessor to today's negligence penalty, holding that reliance on tax matters partner was not objectively reasonable, as the partner was also the promoter of the shelter); *Hitchen v. Comm'r*, T.C. Memo. 2004-265 (reliance on promoters of investment unreasonable).

27 *Benson v. Comm'r*, T.C. Memo. 2004-272 (holding that taxpayer is ultimately responsible for the correctness of the tax return and must furnish the return preparer with the information necessary for preparing the return). *See also CMA Consolidated, Inc. v. Comm'r*, T.C. Memo. 2005-16; *Delaware Corp. v. Comm'r*, T.C. Memo. 2004-280.

When courts are making fact and circumstance determinations in cases where the taxpayer raises the reasonable cause defense, courts take a number of factors into consideration, including the taxpayer's education, knowledge, and experience.[28] These factors allow the courts to exercise discretion in upholding the penalty in some cases while disallowing the penalty in others, even though the underlying facts are similar. For example, the court will factor into its analysis the taxpayer's ability to understand the tax issue and the issue's level of complexity.[29] Thus, the more sophisticated or educated the taxpayer, the less likely it is that the reasonable cause defense will prevail. The existence of reasonable cause in any given case depends on all the facts and circumstances of the case,[30] and what constitutes reasonable for one taxpayer may not be reasonable for another.

CONCLUSION

Courts overturned the IRS's imposition of the IRC § 6662(b)(1) penalty in whole or in part in 32 percent of the opinions reviewed, an increase of 13 percent over last year's percentage of taxpayer victories.[31] Taxpayers continued to experience problems that are largely of their own making (*e.g.*, failure to keep adequate and complete records, not independently reviewing tax returns prepared by professionals, and not providing any evidence or argument to demonstrate reasonable cause) in litigating this issue. Taxpayer victories in a percentage of the cases do, however, raise the question of whether the IRS always exercises proper oversight on the imposition of the negligence penalty.

The accuracy-related penalty has appeared in the Most Litigated Issues section of the National Taxpayer Advocate's Annual Report to Congress for four of the past six years.[32] As discussed elsewhere in this report, the IRS abates a large percentage of other types of penalties. This fact, and the significant number of taxpayers who prevailed on reasonable cause in this year's litigated cases, indicate that the IRS should study if the accuracy-related penalty is achieving its original goal of promoting voluntary compliance by encouraging accurate tax returns. At some point, the penalty should be applied less frequently if it is achieving its intended goal.

[28] Treas. Reg. § 1.6664-4(b)(1).

[29] *Malone v. Comm'r*, T.C. Memo. 2005-69 (although taxpayer was a practicing attorney, tax was not his area of expertise and reasonable minds could differ as to the tax implications of his business transactions).

[30] IRM 20.1.1.3.1(1).

[31] National Taxpayer Advocate 2004 Annual Report to Congress 536.

[32] National Taxpayer Advocate 1999 Annual Report to Congress, vol. III-2; National Taxpayer Advocate 2000 Annual Report to Congress 67; National Taxpayer Advocate 2001 Annual Report to Congress 261; and National Taxpayer Advocate 2003 Annual Report to Congress 364.

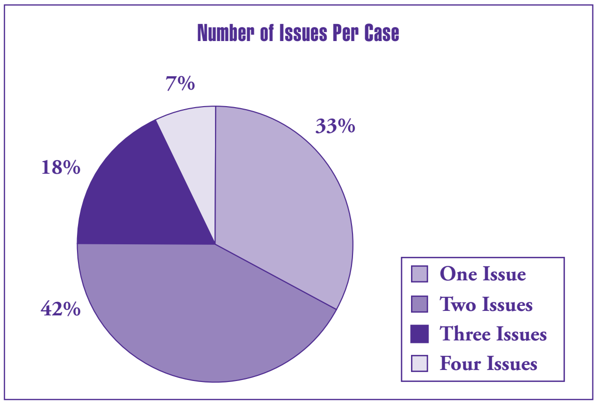
LITIGATED ISSUE #7 FAMILY STATUS ISSUES UNDER INTERNAL REVENUE CODE SECTIONS 2, 21, 24, 32, AND 151

SUMMARY

The Earned Income Tax Credit (EITC),[1] dependency exemption,[2] head of household filing status,[3] child tax credit,[4] and child and dependent care credit[5] are issues that frequently arise in the same cases and involve similar factual determinations. Therefore, this report combines these issues into a single "family status" category. Family status issues involve exemptions, credits, and filing status claimed by taxpayers when they prepare their federal tax returns.

During our review period (June 1, 2004 through May 31, 2005), the federal courts decided 45 cases concerning these issues. Two-thirds of these cases dealt with multiple family status credits and deductions, with the determination of one issue often affecting others. For example, a denial of the dependency exemption will result in the summary denial of the child tax credit, and may jeopardize eligibility for head of household filing status and the child and dependent care credit. The chart below illustrates the extent to which these claims were litigated together.

TABLE 3.7.1, FAMILY STATUS ISSUES PER CASE



[1] IRC § 32.

[2] IRC § 151.

[3] IRC § 2(b).

[4] IRC § 24.

[5] IRC § 21.

PRESENT LAW[6]

Earned Income Tax Credit – IRC § 32

The Earned Income Tax Credit (EITC), a refundable credit for low income working taxpayers, is the nation's largest need-based anti-poverty program.[7] For the 2004 tax year, 22 million taxpayers claimed over $38 billion in credits.[8] Taxpayers may qualify for the credit with a "qualifying child"[9] or with "income-only."[10] For tax year 2005, the maximum EITC for a taxpayer with two or more qualifying children is $4,400, while a taxpayer satisfying the income-only requirements may claim up to $399.[11]

All taxpayers claiming the EITC must meet several general eligibility requirements.[12] Eligibility for the qualifying child credit requires that the child satisfy additional tests.[13] Special tiebreaker rules apply where more than one taxpayer is eligible to claim a qualifying child for the EITC.[14] A taxpayer qualifying under the income-only rules must meet residency[15] and age[16] requirements, and must not be claimed as a dependent by another taxpayer.[17] The maximum earned income for a taxpayer claiming the EITC with a qualifying child is significantly higher than for a taxpayer claiming the income-only EITC.[18]

6 The Working Families Tax Relief Act, Pub. L. No. 108-311 (2004) (WFTRA) made changes to family status definitions that affect all Code sections discussed here, effective starting in 2005. Discussion in this section reflects Code provisions for 2004 and earlier.

7 IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress*, October 2005 1-2 (Oct. 2005); *see also* Frank Sammartino, Eric Toder and Elaine Maag, *Providing Federal Assistance for Low Income Families Through the Tax System: A Primer*, The Urban-Brookings Tax Policy Center, 8 (July 2002) at http://www.urban.org/uploadedpdf/410526.pdf.

8 IRS, *Data Book 2004*, Publication 55B, Table 5, 9. The Data Book 2004 pertains to Fiscal Year 2004, from October 1, 2003 through September 30, 2004.

9 IRC § 32(c)(1)(A)(i).

10 IRC § 32(c)(1)(A)(ii).

11 Rev. Proc. 2004-71.

12 Taxpayers must meet requirements with respect to earned income, (IRC § 32(a)(2)(A)) adjusted gross income (IRC § 32(a)(2)(B)), citizenship or residency (IRC § 32(c)(1)(D)), taxpayer identification number (IRC § 32(c)(1)(F)), filing status (IRC § 32(d)), and maximum investment income (IRC § 32(i)).

13 These include residency (IRC § 32(c)(3)(A)(ii)), relationship (IRC § 32(c)(3)(B)), and age (IRC § 32(c)(3)(C)) tests.

14 IRC § 32(c)(1)(C). If only one of the taxpayers claiming the qualifying child for the EITC is the child's parent, only the parent may treat the child as a qualifying child. If two of the taxpayers are the child's parents, and they do not file a joint return, only the parent with whom the child lived the longest during the taxable year may claim the qualifying child. If the child spent the same amount of time with each parent, only the parent with the higher adjusted gross income will be eligible to claim the qualifying child. Finally, if none of the taxpayers who claim the EITC with respect to the same child is a parent of the child, only the taxpayer with the highest adjusted gross income may treat the child as a qualifying child.

15 IRC § 32(c)(1)(A)(ii)(I).

16 IRC § 32(c)(1)(A)(ii)(II).

17 IRC § 32(c)(1)(A)(ii)(III).

18 To claim the EITC for tax year 2005, the taxpayer's AGI must be less than $35,263 ($37,263 for married taxpayers filing jointly) if the taxpayer has more than one qualifying child, $31,030 ($33,030 for married filing jointly) if the taxpayer has one qualifying child, or $11,750 ($13,750 for married filing jointly) if the taxpayer does not have any qualifying children. (Rev. Proc. 2004-71).

Dependency Exemption – IRC § 151

IRC § 151 governs dependency and personal exemptions. A taxpayer may claim a dependency exemption for each individual who qualifies as a dependent under IRC §152[19] and either (1) is a child of the taxpayer who has not attained the age of 19 by the end of the taxable year (24 for full-time students or any age if permanently and totally disabled), or (2) has gross income for the calendar year that is less than the exemption amount.[20]

Head of Household – IRC § 2(b)

The head of household filing status under IRC § 2(b) entitles a taxpayer to a larger standard deduction and a more favorable tax rate than a single taxpayer or a married taxpayer filing separately.[21] A taxpayer must meet two main requirements to qualify as a head of household. First, he or she must be unmarried or "considered unmarried" at the end of the taxable year.[22] Second, the taxpayer must maintain a household that is the principal place of abode of an individual for whom the taxpayer is entitled to a dependency exemption under IRC §151, with one exception: where a taxpayer provides over half the cost of maintaining a household that is the principal place of abode for a son or daughter, the taxpayer may file as head of household notwithstanding his inability to claim the dependency exemption.[23]

[19]IRC § 152 defines a dependent as follows: A dependent is an individual who is a U.S. citizen and receives more than half of his or her support from the taxpayer and is either: (1) A son or daughter of the taxpayer, or a descendant of either, (2) A stepson or stepdaughter of the taxpayer, (3) A brother, sister, stepbrother, or stepsister of the taxpayer, (4) The father or mother of the taxpayer, or an ancestor of either, (5) A stepfather or stepmother of the taxpayer, (6) A son or daughter of a brother or sister of the taxpayer, (7) A brother or sister of the father or mother of the taxpayer, (8) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer, or (9) An individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to § 7703, of the taxpayer) who, for the taxable year of the taxpayer, has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household. IRC § 152(a). Additionally, a child meets the definition of a dependent if that child: (a) is the legally adopted child of the taxpayer; (b) is a member of the individual's household through placement by an authorized placement agency for legal adoption by the taxpayer; and (c) is the foster child of the individual and, for the taxable year of that taxpayer, resides with the taxpayer and is a member of that household. IRC § 152(b)(2).

[20]IRC § 151(c)(1). For tax year 2005, the exemption amount is $3,200 (Rev. Proc. 2004-71).

[21]For tax year 2005, the standard deduction for head of household is $7,300 (Rev. Proc. 2004-71).

[22] IRC § 2(b)(1). Under IRC § 2(b)(2), a taxpayer is not considered married if he is legally separated from his spouse under a decree of divorce or separate maintenance, or if his spouse is a nonresident alien. A taxpayer is also considered unmarried if he meets the requirements set forth in IRC § 7703(b), which requires, among other things, that the taxpayer has lived apart from his spouse during the last six months of the taxable year, and furnished over one-half the cost of maintaining his household as the principal home of a child as defined in IRC § 151(c)(3). A taxpayer whose spouse died during the taxable year is considered married for that year. IRC § 2(b)(2)(D).

[23]A taxpayer may qualify as head of household if the taxpayer is not eligible for the dependency exemption provided the taxpayer maintains a household for a son or daughter and is unmarried at the end of the year. To maintain a household, the taxpayer must pay more than fifty percent of the cost of maintaining the home. Treas. Reg. § 1.2-2(b)(3)(i).

Child Tax Credit – IRC § 24

Eligibility to claim the child tax credit, as codified in IRC § 24, is based on a three-part test. A taxpayer must be able to claim a dependency exemption for the child, the child must be under 17 years of age, and the child must bear a relationship to the taxpayer described in IRC § 32(c)(3)(B).[24] The child tax credit is applied to any taxes due and is refundable for some taxpayers.[25]

Child and Dependent Care Credit - IRC § 21

The child and dependent care credit under IRC § 21 is intended to help offset the child and dependent care expenses a taxpayer incurs so that the taxpayer may pursue employment. To claim the credit, the taxpayer must have contributed over half the cost of maintaining a household in which one or more "qualifying individuals" reside.[26] Taxpayers must also meet requirements with respect to filing status[27] and earned income.[28] A taxpayer may claim a credit of up to 35 percent[29] of child and dependent care expenses paid, up to a maximum of $3,000 for a taxpayer with one qualifying individual or $6,000 with two or more qualifying individuals.[30] A taxpayer may not claim this credit based on household or care expenses paid to a relative unless the relative is age 19 or older and not a dependent of the taxpayer.[31]

ANALYSIS OF LITIGATED CASES

Pro Se Analysis

Taxpayers were represented by counsel in only six of 45 cases litigated this year.[32] Many of the cases were highly fact-specific and involved a complicated web of statutory provisions. It appeared that many of the taxpayers did not understand either the law or how to

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[24] IRC § 24(c). The child tax credit adopts the EITC relationship test, in which a qualifying child may be (1) a son, daughter, stepson, stepdaughter, or descendant of any such individual, (2) a brother, sister, stepbrother, stepsister, or a descendant of any such individual, or (3) a foster child placed with the taxpayer by an authorized placement agency. For tax year 2004 and earlier, the relationship test includes a requirement that the taxpayer care for individuals in the latter two categories as the taxpayer's own child.

[25] IRC § 24(d).

[26] IRC §§ 21(a)(1), 21(e)(1). A "qualifying individual" is (1) a dependent of the taxpayer under the age of 13 and with respect to whom the taxpayer is entitled to a dependency exemption, or (2) a dependent or a spouse who is physically or mentally unable to care for himself. IRC § 21(b)(1).

[27] IRC § 21(e)(2).

[28] IRC § 21(d)(1). Special rules with respect to the calculation of earned income apply for a spouse of a taxpayer who is a student or who is incapable of caring for himself. IRC § 21(d)(2).

[29] This percentage is reduced one percentage point for every $2,000 the taxpayer's adjusted gross income exceeds $15,000, but not below 20 percent. IRC § 21(a)(2).

[30] IRC § 21(c).

[31] IRC §21(e)(6).

[32] *Brettin v. Comm'r*, T. C. Summ. Op. 2004-95, *Hutchinson v. Comm'r*, T.C. Summ. Op. 2005-58, *In re Adkins*, 2004 WL 2334716 (Bankr. D. Kan. 2004), *In re James*, 406 F.3d 1340 (11th Cir. 2005), *In re Schwarz*, 314 B.R. 433 (D. Neb. 2004), *Jondahl v. Comm'r*, T.C. Memo 2005-55.

present relevant evidence. The assistance of counsel might have made a difference in the outcome of these cases. A detailed listing of all family status cases analyzed appears in Table 7 in Appendix 3.

Earned Income Tax Credit - IRC § 32

Introduction

Twenty cases involving the EITC were litigated during the reporting period,[33] down from 28 in the previous year.[34] The cases essentially fell into three general categories: (1) Qualifying Child, (2) Income Related, and (3) Married Person Filing Status.

Qualifying Child

Eleven cases involved the issue of whether a taxpayer had a "qualifying child" for claiming the EITC,[35] with all cases decided against the taxpayer. As previously noted, a qualifying child must meet age, residency, and relationship requirements[36] and may only be claimed for EITC purposes by one taxpayer.[37]

In six cases, taxpayers were not able to show that the children lived with them for more than half of the taxable year.[38] Two cases were decided against the taxpayers because they failed to demonstrate that they cared for the children as their own.[39] One case involved the age test, in which the court determined the taxpayer's stepson was not a qualifying child because he was 21 years old and not a full-time student.[40]

33 *Booker v. Comm'r*, T.C. Summ. Op. 2004-92, *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Diaz v. Comm'r*, T.C. Memo. 2004-145, *In re Adkins*, 2004 WL 2334716 (Bankr. D. Kan. 2004), *In re James*, 406 F.3d 1340 (11th Cir. 2005), *Jones v. Comm'r*, T.C. Summ. Op. 2004-133, *Joseph v. Comm'r*, T.C. Summ. Op. 2004-137, *Lear v. Comm'r*, T.C. Memo 2004-253, *Mbachu v. Comm'r*, T.C. Summ. Op. 2004-168, *Mbanu v. Comm'r*, T.C. Summ. Op. 2005-56, *Muncy v. Comm'r*, T.C. Summ. Op. 2005-20, *Myers v. Comm'r*, T.C. Summ. Op. 2005-15, *Ogu v. Comm'r*, T.C. Summ. Op. 2004-87, *Petty v. Comm'r*, T.C. Memo 2004-144, *Rogers v. Comm'r*, T.C. Memo. 2004-245, *Sampson v. Comm'r*, T.C. Summ. Op. 2005-30, *Somsukcharean v. Comm'r*, T.C. Summ. Op. 2005-49, *Toney v. Comm'r*, T.C. Memo. 2004-165, *Urena v. Comm'r*, T.C. Summ. Op. 2004-138, *Varner v. Comm'r*, T.C. Summ. Op. 2004-111.

34 National Taxpayer Advocate 2004 Annual Report to Congress 560.

35 *Booker v. Comm'r*, T.C. Summ. Op. 2004-92, *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Jones v. Comm'r*, T.C. Summ. Op. 2004-133, *Joseph v. Comm'r*, T.C. Summ. Op. 2004-137, *Lear v. Comm'r*, T.C. Memo 2004-253, *Mbachu v. Comm'r*, T.C. Summ. Op. 2004-168, *Muncy v. Comm'r*, T.C. Summ. Op. 2005-20, *Ogu v. Comm'r*, T.C. Summ. Op. 2004-87, *Somsukcharean v. Comm'r*, T.C. Summ. Op. 2005-49, *Urena v. Comm'r*, T.C. Summ. Op. 2004-138, *Varner v. Comm'r*, T.C. Summ. Op. 2004-111.

36 IRC § 32(c)(3).

37 IRC § 32(c)(1)(C).

38 *Jones v. Comm'r*, T.C. Summ. Op. 2004-133, *Mbachu v. Comm'r*, T.C. Summ. Op. 2004-168, *Muncy v. Comm'r*, T.C. Summ. Op. 2005-20, *Ogu v. Comm'r*, T.C. Summ. Op. 2004-87, *Urena v. Comm'r*, T.C. Summ. Op. 2004-138, *Varner v. Comm'r*, T.C. Summ. Op. 2004-111.

39 *Booker v. Comm'r*, T.C. Summ. Op. 2004-92, *Somsukcharean v. Comm'r*, T.C. Summ. Op. 2005-49. The WFTRA eliminated the requirement to care for children as one's own, which would have changed the outcome in *Somsukcharean*. In *Booker*, however, because the child claimed by the taxpayer did not meet the relationship test, the EITC would still have been denied.

40 *Jones v. Comm'r*, T.C. Summ. Op. 2004-133.

Two cases involved qualifying children who could be claimed by more than one taxpayer.[41] Because only one taxpayer may claim a qualifying child for the EITC, the Tax Court applied the tiebreaker rules of IRC § 31(c)(1)(C) in each case and determined that only the taxpayer with the higher adjusted gross income (AGI) was entitled to claim the child.

Income-Related

Four taxpayers were denied the EITC due to income qualification issues.[42] One taxpayer did not meet the central requirement of the earned income tax credit – that is, he did not have any earned income.[43] In the other three cases, taxpayers disputed whether certain items of income should be considered "earned income" for the purposes of calculating the EITC:[44] *Rogers v. Commissioner* (wages earned in a penal institution), *Myers v. Commissioner* (trust income), and *Petty v. Commissioner* (gambling winnings). In all three cases, the court found the items in dispute were includible as earned income, thus rendering the taxpayers in *Myers* and *Sampson* ineligible to claim the EITC and reducing the credit for the taxpayer in *Petty*.

Married Taxpayer Filing Status

Four cases involved taxpayers whose filing statuses were in dispute.[45] Under IRC § 32(d), a married taxpayer must file a joint tax return to claim the EITC. One taxpayer conceded that he was married and had not filed a joint return.[46] The other three cases involved determinations under IRC § 7703(b). Two taxpayers were unable to provide evidence that their spouses did not live with them during the last six months of the taxable year.[47] In the remaining case, the taxpayer did not qualify as unmarried because he did not provide over half the cost of maintaining a household that was the principal home for more than one-half of the taxable year of a child for whom he was entitled to claim a dependency exemption.[48]

[41] *Joseph v. Comm'r*, T.C. Summ. Op. 2004-137, Lear v. Comm'r, T.C. Memo 2004-253.

[42] *Myers v. Comm'r*, T.C. Summ. Op. 2005-15, *Petty v. Comm'r*, T.C. Memo 2004-144, *Rogers v. Comm'r*, T.C. Memo. 2004-245, *Sampson v. Comm'r*, T.C. Summ. Op. 2005-30.

[43] *Sampson v. Comm'r*, T.C. Summ. Op. 2005-30.

[44] *Petty v. Comm'r*, T.C. Memo 2004-144, *Rogers v. Comm'r*, T.C. Memo. 2004-245, *Myers v. Comm'r*, T.C. Summ. Op. 2005-15.

[45] *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Diaz v. Comm'r*, T.C. Memo. 2004-145, *Mbanu v. Comm'r*, T.C. Summ. Op. 2005-56, *Toney v. Comm'r*, T.C. Memo. 2004-165.

[46] *Mbanu v. Comm'r*, T.C. Summ. Op. 2005-56.

[47] *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Diaz v. Comm'r*, T.C. Memo. 2004-145.

[48] *Toney v. Comm'r*, T.C. Memo. 2004-165.

Dependency Exemption – IRC § 151

The dependency exemption was litigated in 31 family status cases,[49] with taxpayers prevailing in two of them.[50]

Eighteen dependency exemption cases involved the application of IRC § 152(e), the support test for a child of divorced parents.[51] Under IRC § 152(e), the exemption goes to the custodial parent unless that parent signs a written declaration releasing the exemption.[52] Taxpayers in eight divorced parent cases were noncustodial parents claiming the dependency exemption based on provisions in their divorce decrees.[53] Although the language in the decrees appeared to grant the noncustodial parents the exemptions, the decrees did not conform to the statutory requirements of IRC § 152(e).[54] Thus, all claims were denied, as "it is well settled that state courts, by their decisions, cannot determine issues of federal tax law."[55]

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49 *Allsopp v. Comm'r*, T.C. Summ. Op. 2004-154, *Bernardo v. Comm'r*, T.C. Memo. 2004-199, *Booker v. Comm'r*, T.C. Summ. Op. 2004-92, *Bouch v. Comm'r*, T.C. Summ. Op. 2004-167, *Boulden v. Comm'r*, T.C. Summ. Op. 2004-124, *Brettin v. Comm'r*, T. C. Summ. Op. 2004-95, *Brunner v. Comm'r*, T.C. Memo. 2004-187, *aff'd* 2005 U.S. App. LEXIS 14885 (3rd Cir., July 8, 2005), *Caputi v. Comm'r*, T.C. Memo. 2004-283, *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Corrigan v. Comm'r*, T.C. Memo. 2005-119, *Curello v. Comm'r*, T.C. Summ. Op. 2005-23, *Elkins v. Comm'r*, T.C. Summ. Op. 2004-84, *Emanie v. Comm'r*, T.C. Summ. Op. 2004-78, *Howard-Crowley v. Comm'r*, T.C. Summ. Op. 2004-150 *Hubbard v. Comm'r*, T.C. Summ. Op. 2004-148, *Hutchinson v. Comm'r*, T.C. Summ. Op. 2005-58, *Jones v. Comm'r*, T.C. Summ. Op. 2004-133, *Joseph v. Comm'r*, T.C. Summ. Op. 2004-137, *Lear v. Comm'r*, T.C. Memo 2004-253, *McNair v. Comm'r*, T.C. Summ. Op. 2004-115, *Montwillo v. Comm'r*, T.C. Summ. Op. 2004-123, *Sampson v. Comm'r*, T.C. Summ. Op. 2005-30, *Scott v. Comm'r*, T.C. Summ. Op. 2004-129, *Somsukcharean v. Comm'r*, T.C. Summ. Op. 2005-49, *Spanier v. Comm'r*, T.C. Summ. Op. 2004-106, *Szasz v. Comm'r*, T.C. Summ. Op. 2004-169, *Toney v. Comm'r*, T.C. Memo. 2004-165, *Varner v. Comm'r*, T.C. Summ. Op. 2004-111, *Wells v. Comm'r*, T.C. Summ. Op. 2004-153, *Wentland v. Comm'r*, T.C. Summ. Op. 2004-134, *Werther v. Comm'r*, T.C. Summ. Op. 2005-28.

50 *Corrigan v. Comm'r*, T.C. Memo. 2005-119, *Elkins v. Comm'r*, T.C. Summ. Op. 2004-84.

51 *Allsopp v. Comm'r*, T.C. Summ. Op. 2004-154, *Bouch v. Comm'r*, T.C. Summ. Op. 2004-167, *Boulden v. Comm'r*, T.C. Summ. Op. 2004-124, *Caputi v. Comm'r*, T.C. Memo. 2004-283, *Corrigan v. Comm'r*, T.C. Memo. 2005-119, *Curello v. Comm'r*, T.C. Summ. Op. 2005-23, *Elkins v. Comm'r*, T.C. Summ. Op. 2004-84, *Emanie v. Comm'r*, T.C. Summ. Op. 2004-78, *Howard-Crowley v. Comm'r*, T.C. Summ. Op. 2004-150, *Hutchinson v. Comm'r*, T.C. Summ. Op. 2005-58, *Montwillo v. Comm'r*, T.C. Summ. Op. 2004-123, *Muncy v. Comm'r*, T.C. Summ. Op. 2005-20, *Scott v. Comm'r*, T.C. Summ. Op. 2004-129, *Spanier v. Comm'r*, T.C. Summ. Op. 2004-106, *Varner v. Comm'r*, T.C. Summ. Op. 2004-111, *Wells v. Comm'r*, T.C. Summ. Op. 2004-153, *Werther v. Comm'r*, T.C. Summ. Op. 2005-28. IRC § 152(e) also applies in the case of parents that have never been married. 121 T.C. 245, 251 (2003).

52 IRC § 152(e)(2).

53 *Allsopp v. Comm'r*, T.C. Summ. Op. 2004-154, *Curello v. Comm'r*, T.C. Summ. Op. 2005-23, *Emanie v. Comm'r*, T.C. Summ. Op. 2004-78, *Howard-Crowley v. Comm'r*, T.C. Summ. Op. 2004-150, *Muncy v. Comm'r*, T.C. Summ. Op. 2005-20, *Scott v. Comm'r*, T.C. Summ. Op. 2004-129, *Spanier v. Comm'r*, T.C. Summ. Op. 2004-106, *Werther v. Comm'r*, T.C. Summ. Op. 2005-28.

54 To meet the requirements of IRC § 152(e), a parent may complete an IRS Form 8332 or submit a declaration that conforms to the substance of Form 8332. Treas. Reg. § 1.152-4T(a) A-3. Form 8332 requires a taxpayer to provide (1) the name of the noncustodial parent claiming the exemption (2) the noncustodial parent's social security number, (3) the name of the child or children for whom the exemption is released, (4) the years for which the exemption is released, (5) the signature of the custodial parent and the date of the signature, and (6) the custodial parent's social security number. IRS Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents* (December 2003).

55 *Allsopp v. Comm'r*, T.C. Summ. Op. 2004-154.

In addition to the divorced parent cases, 11 cases involved the issue of whether the individual for whom the exemption was claimed qualified as a "dependent."[56] To be classified as the dependent of a taxpayer for the years in question, an individual must receive over half of his or her support from the taxpayer and meet either a relationship or a residence test.[57] Ten taxpayers were denied the dependency exemption because they were unable to provide sufficient evidence that they had provided over half of the individual's support.[58] The taxpayer in *McNair v. Commissioner* was denied the exemption because none of the children for whom she tried to claim it lived with her during the taxable years in question.[59]

One noncustodial parent who was denied the dependency exemption challenged the constitutionality of IRC § 152(e) on equal protection grounds. However, the Tax Court upheld the constitutionality of the provision under the rational basis standard, as it had a "legitimate congressional purpose."[60] In two other cases, the issue of whether the taxpayer was entitled to the dependency exemption became moot because of determinations regarding other issues.[61]

Head of Household Filing Status – IRC § 2(b)

Eighteen cases involving head of household status were litigated during the reporting period,[62] with a single taxpayer prevailing on his claim.[63]

Nine taxpayers were denied head of household filing status because they failed to demonstrate that they maintained a household that was the primary place of abode for a

56 *Bernardo v. Comm'r*, T.C. Memo. 2004-199, *Booker v. Comm'r*, T.C. Summ. Op. 2004-92, *Brunner v. Comm'r*, T.C. Memo. 2004-187, *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Joseph v. Comm'r*, T.C. Summ. Op. 2004-137, *Lear v. Comm'r*, T.C. Memo 2004-253, *McNair v. Comm'r*, T.C. Summ. Op. 2004-115, *Somsukcharean v. Comm'r*, T.C. Summ. Op. 2005-49, *Szasz v. Comm'r*, T.C. Summ. Op. 2004-169, *Toney v. Comm'r*, T.C. Memo. 2004-165, *Wentland v. Comm'r*, T.C. Summ. Op. 2004-134.

57 IRC § 152(a).

58 *Bernardo v. Comm'r*, T.C. Memo. 2004-199, *Booker v. Comm'r*, T.C. Summ. Op. 2004-92, *Brunner v. Comm'r*, T.C. Memo. 2004-187, *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Joseph v. Comm'r*, T.C. Summ. Op. 2004-137, *Lear v. Comm'r*, T.C. Memo 2004-253, *Somsukcharean v. Comm'r*, T.C. Summ. Op. 2005-49, *Szasz v. Comm'r*, T.C. Summ. Op. 2004-169, *Toney v. Comm'r*, T.C. Memo. 2004-165, *Wentland v. Comm'r*, T.C. Summ. Op. 2004-134. It seems likely that some of these cases would have had different results under WFTRA.

59 *McNair v. Comm'r*, T.C. Summ. Op. 2004-115.

60 *Caputi v. Comm'r*, T.C. Memo. 2004-283.

61 In *Jones v. Comm'r*, the court found the dependency exemption would not reduce the taxpayer's taxable income. T.C. Summ. Op. 2004-133. In *Sampson v. Comm'r*, the court determined the taxpayer did not have earned income for the year. T.C. Summ. Op. 2005-30.

62 *Bernardo v. Comm'r*, T.C. Memo. 2004-199, *Booker v. Comm'r*, T.C. Summ. Op. 2004-92, *Caputi v. Comm'r*, T.C. Memo. 2004-283, *Castleton v. Comm'r*, T.C. Memo 2005-58, *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Elkins v. Comm'r*, T.C. Summ. Op. 2004-84, *Emanie v. Comm'r*, T.C. Summ. Op. 2004-78, *Hubbard v. Comm'r*, T.C. Summ. Op. 2004-148, *Jondahl v. Comm'r*, T.C. Memo 2005-55, *Mbachu v. Comm'r*, T.C. Summ. Op. 2004-168, *Mbanu v. Comm'r*, T.C. Summ. Op. 2005-56, *Montwillo v. Comm'r*, T.C. Summ. Op. 2004-123, *Muncy v. Comm'r*, T.C. Summ. Op. 2005-20, *Ogu v. Comm'r*, T.C. Summ. Op. 2004-87, *Sampson v. Comm'r*, T.C. Summ. Op. 2005-30, *Szasz v. Comm'r*, T.C. Summ. Op. 2004-169, *Toney v. Comm'r*, T.C. Memo. 2004-165, *Varner v. Comm'r*, T.C. Summ. Op. 2004-111.

63 *Hubbard v. Comm'r*, T.C. Summ. Op. 2004-148.

dependent.[64] In *Bernardo v. Commissioner*, a mother tried to file as head of household, claiming her home was her daughter's principal place of abode during the taxable year, though the daughter was frequently away pursuing her singing career. An individual may have "temporary absences from the household due to special circumstances" and still be considered a member of the taxpayer's household,[65] but the evidence implied that had the daughter found paid work elsewhere, she would probably have stayed there. The court found this inconsistent with the daughter having the same principal place of abode as the taxpayer, and denied the taxpayer head of household status.

Marital status was an issue in five filing status cases.[66] In two of these cases, the taxpayers admitted they were married,[67] one case involved an IRC § 7703(b) determination,[68] and the other two were based on sufficiency of evidence.[69]

Courts denied head of household filing status in two cases because the taxpayers had been denied exemptions for their dependents.[70] One taxpayer's claim was rendered moot by another determination.[71]

Finally, one taxpayer was denied head of household filing status solely because he could not show that he had contributed over half of the cost of maintaining a household.[72] We note here that the definition of "head of household" was modified by the Working Families Tax Relief Act.[73]

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64 *Bernardo v. Comm'r*, T.C. Memo. 2004-199, *Caputi v. Comm'r*, T.C. Memo. 2004-283, *Castleton v. Comm'r*, T.C. Memo 2005-58, *Emanie v. Comm'r*, T.C. Summ. Op. 2004-78, *Montwillo v. Comm'r*, T.C. Summ. Op. 2004-123, *Muncy v. Comm'r*, T.C. Summ. Op. 2005-20, *Ogu v. Comm'r*, T.C. Summ. Op. 2004-87, *Toney v. Comm'r*, T.C. Memo. 2004-165, *Varner v. Comm'r*, T.C. Summ. Op. 2004-111.

65 Treas. Reg. § 1.2-2(c)(1).

66 *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Hubbard v. Comm'r*, T.C. Summ. Op. 2004-148, *Jondahl v. Comm'r*, T.C. Memo 2005-55, *Mbachu v. Comm'r*, T.C. Summ. Op. 2004-168, *Mbanu v. Comm'r*, T.C. Summ. Op. 2005-56.

67 *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Mbanu v. Comm'r*, T.C. Summ. Op. 2005-56.

68 *Mbachu v. Comm'r*, T.C. Summ. Op. 2004-168.

69 *Hubbard v. Comm'r*, T.C. Summ. Op. 2004-148, *Jondahl v. Comm'r*, T.C. Memo 2005-55.

70 *Booker v. Comm'r*, T.C. Summ. Op. 2004-92, *Szasz v. Comm'r*, T.C. Summ. Op. 2004-169. The taxpayer can claim head of household filing status for maintaining a household that is considered the principal place of abode for the taxpayer's unmarried son, daughter, stepson, stepdaughter, or unmarried descendent of the taxpayer's son or daughter. For all other qualifying individuals, including the taxpayer's mother or father, the taxpayer must be able to claim the qualifying individual as a dependent in order to qualify for head of household filing status. IRC § 2(b)(1)(B).

71 *Sampson v. Comm'r*, T.C. Summ. Op. 2005-30.

72 *Elkins v. Comm'r*, T.C. Summ. Op. 2004-84.

73 Pub. L. No. 108-311, Working Families Tax Relief Act of 2004 (WFTRA). WFTRA set a uniform definition of a "qualifying child" for tax benefits such as head of household filing status, dependency exemptions, child tax credit, child and dependent care credit, and earned income tax credit. For the child and dependent care credit, the taxpayer is no longer required to pay over half the cost of maintaining a household for the qualifying child. The taxpayer is still required to pay over half the cost of maintaining a household which is the primary residence for the qualifying child or qualifying relative in order to qualify for head of household filing status.

MOST LITIGATED

MOST LITIGATED TAX ISSUES

Child Tax Credit – IRC § 24

Sixteen cases involving the child tax credit were litigated during the reporting period.[74] In addition to the child's age and residency requirements, a taxpayer must also be able to claim a dependency exemption for the child.[75] Because qualifying for the dependency exemption is required to claim the child tax credit, the child tax credit will be summarily denied where the dependency exemption is denied, as it was in 15 cases.[76] In *Castleton v. Commissioner*, the IRS conceded the taxpayer was entitled to the dependency exemption, and the child met the age and residency requirements, so the credit was granted.[77]

Child and Dependent Care Credit – IRC § 21

The Child and Dependent Care Credit was litigated in three cases,[78] with a taxpayer prevailing in one. Two cases turned on the question of whether there was "sufficient evidence" to claim the credit. In both *Elkins v. Commissioner* and *Hubbard v. Commissioner*, the issue of whether the taxpayers had qualifying children was not in dispute. However, the IRS challenged both claims based on what it asserted was insufficient substantiation for the credit. In *Hubbard*, the Tax Court found that the respondent's disallowance of the child and dependent care credit was unwarranted.[79] In *Elkins*, however, the court found significant evidence that the dependent care center the taxpayer claimed to have used was not in operation during the year in issue, and sustained the IRS's disallowance of the credit.[80]

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74 *Allsopp v. Comm'r*, T.C. Summ. Op. 2004-154, *Bouch v. Comm'r*, T.C. Summ. Op. 2004-167, *Boulden v. Comm'r*, T.C. Summ. Op. 2004-124, *Brettin v. Comm'r*, T. C. Summ. Op. 2004-95, *Caputi v. Comm'r*, T.C. Memo. 2004-283, *Castleton v. Comm'r*, T.C. Memo 2005-58, *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Curello v. Comm'r*, T.C. Summ. Op. 2005-23, *Elkins v. Comm'r*, T.C. Summ. Op. 2004-84, *McNair v. Comm'r*, T.C. Summ. Op. 2004-115, *Montwillo v. Comm'r*, T.C. Summ. Op. 2004-123, *Muncy v. Comm'r*, T.C. Summ. Op. 2005-20, *Somsukcharean v. Comm'r*, T.C. Summ. Op. 2005-49, *Wells v. Comm'r*, T.C. Summ. Op. 2004-153, *Werther v. Comm'r*, T.C. Summ. Op. 2005-28, *Scott v. Comm'r*, T.C. Summ. Op. 2004-129.

75 IRC § 24(c)(1)(A)-(C).

76 *Allsopp v. Comm'r*, T.C. Summ. Op. 2004-154, *Bouch v. Comm'r*, T.C. Summ. Op. 2004-167, *Boulden v. Comm'r*, T.C. Summ. Op. 2004-124, *Brettin v. Comm'r*, T. C. Summ. Op. 2004-95, *Caputi v. Comm'r*, T.C. Memo. 2004-283, *Colstock v. Comm'r*, T.C. Summ. Op. 2005-54, *Curello v. Comm'r*, T.C. Summ. Op. 2005-23, *Elkins v. Comm'r*, T.C. Summ. Op. 2004-84, *McNair v. Comm'r*, T.C. Summ. Op. 2004-115, *Montwillo v. Comm'r*, T.C. Summ. Op. 2004-123, *Muncy v. Comm'r*, T.C. Summ. Op. 2005-20, *Somsukcharean v. Comm'r*, T.C. Summ. Op. 2005-49, *Wells v. Comm'r*, T.C. Summ. Op. 2004-153, *Werther v. Comm'r*, T.C. Summ. Op. 2005-28, *Scott v. Comm'r*, T.C. Summ. Op. 2004-129.

77 *Castleton v. Comm'r*, T.C. Memo 2005-58.

78 *Elkins v. Comm'r*, T.C. Summ. Op. 2004-84, *Hubbard v. Comm'r*, T.C. Summ. Op. 2004-148, *McNair v. Comm'r*, T.C. Summ. Op. 2004-115.

79 *Hubbard v. Comm'r*, T.C. Summ. Op. 2004-148.

80 *Elkins v. Comm'r*, T.C. Summ. Op. 2004-84.

CONCLUSION

Family status provisions are fundamental components of the tax code, yet they have complicated and sometimes conflicting eligibility standards. Because of this, tax filing has become an increasingly difficult exercise for low income to middle income families. As the above analysis shows, taxpayers who wish to claim the family status credits and deductions often do not understand the qualification requirements or how to properly satisfy them. Further, such taxpayers often lack legal representation when they go before the courts. The changes to family status provisions made by the Working Families Tax Relief Act, effective in 2005, may ease the burden somewhat through the uniform definition of a qualifying child, though the changes would not have affected the outcome of the majority of the cases here.

LITIGATED ISSUE #8 RELIEF FROM JOINT AND SEVERAL LIABILITY UNDER INTERNAL REVENUE CODE SECTION 6015

SUMMARY

Married persons may elect to file their income tax returns jointly or separately. Spouses filing joint federal tax returns are jointly and severally liable for any deficiency or tax due.[1] Joint and several liability enables the IRS to collect the entire amount owed from either taxpayer.

IRC § 6015 provides three avenues for relief from joint and several liability. Section 6015(b) provides relief for deficiencies and is similar to the innocent spouse relief formerly provided in the repealed section 6013(e). Section 6015(c) also provides relief for deficiencies and allocates the liability to each spouse. Section 6015(f) provides equitable relief from deficiencies and underpayments if a taxpayer is not eligible for relief under 6015(b) or (c). A taxpayer generally files Form 8857, *Request for Innocent Spouse Relief*, to elect relief. We reviewed 45 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2004, and May 31, 2005.

PRESENT LAW

Traditional Innocent Spouse Relief Under IRC § 6015(b)

IRC § 6015(b)(1) provides full or partial relief from joint and several liability if the requesting taxpayer can demonstrate that:

1. A joint return was filed;
2. There was an understatement of tax attributable to erroneous items of the nonrequesting taxpayer;
3. Upon signing the return, the requesting taxpayer did not know or have reason to know of the understatement;
4. Taking into account all the facts and circumstances, it is inequitable to hold the requesting taxpayer liable; and
5. Requesting spouse made the election within two years after the IRS began collection activities with respect to the requesting taxpayer.

Allocation of Liability Under IRC § 6015(c)

IRC §6015(c) relieves the requesting taxpayer of liability for deficiencies allocable solely to the nonrequesting taxpayer. To obtain relief under this section, the requesting taxpayer must demonstrate that:

1. A joint return was filed;
2. At the time the election is made, the taxpayers are unmarried, legally separated, or have not lived in the same household for the 12 months immediately preced-

[1] IRC § 6013(d)(3).

ing the election; and

3. The election was made within two years after the IRS began collection activities with respect to the requesting taxpayer.

This election separates or allocates the deficiency arising under the joint return and allocates to each joint filer that portion of the deficiency attributable to each joint filer as calculated under the allocation provisions of § 6015(d).

A taxpayer is ineligible to make an election under IRC § 6015(c) if the IRS demonstrates that, at the time the return was signed, the requesting taxpayer had "actual knowledge" of any item giving rise to the deficiency. Additionally, relief is denied for amounts attributable to fraud, fraudulent schemes, or the certain transfers of disqualified assets.

Equitable Relief Under IRC § 6015(f)

IRC § 6015(f) provides equitable relief from deficiencies and underpayments for taxpayers who can demonstrate that:

1. Relief under IRC § 6015(b) or (c) is unavailable; and
2. Taking into account all the facts and circumstances, it would be inequitable to hold the taxpayer liable for the underpayment or deficiency.

IRC § 6015(f) directed the Secretary to issue procedures governing equitable relief. Rev. Proc. 2003-61 lists some of the factors considered by the IRS in determining whether equitable relief is appropriate.[2] These factors include marital status, economic hardship, knowledge or reason to know, legal obligations of the nonrequesting spouse, significant benefit to the requesting spouse, compliance with income tax laws, and abuse.

Unlike IRC § 6015(b) and (c), which relieve taxpayers from understatements of tax, equitable relief under IRC § 6015(f) is available for both understatements and underpayments.

[2] Rev. Proc. 2003-61, 2003-2 C.B. 296, superseding Rev. Proc. 2000-15, 2000-1 C.B. 447. Section 4.01 of this revenue procedure sets out seven threshold conditions that must be met by the taxpayer to be eligible for relief under IRC § 6015(f). The seven threshold conditions are: the requesting spouse filed a joint return for the taxable year for which he or she seeks relief; the relief is not available to the requesting spouse under IRC § 6015(b) or (c); the requesting spouse applies for relief no later than two years after the date of the IRS's first collection activity; no assets were transferred between the spouses as part of a fraudulent scheme; the nonrequesting spouse did not transfer disqualified assets to the requesting spouse; the requesting spouse did not file, or fail to file, with a fraudulent intent; and the income tax liability from which the relief is sought is attributable to the nonrequesting spouse. Section 4.02 establishes three elements the taxpayer can prove to qualify for relief of an underpayment: spouses are no longer married, are legally separated, or not members of the same household for the last 12 months; the requesting spouse had no knowledge, or reason to know, that the nonrequesting spouse would not pay the income tax liability; and the requesting spouse will suffer economic hardship if the IRS does not provide relief. Finally, if the taxpayer satisfies the threshold conditions, but fails to prove the section 4.02 elements, section 4.03 sets out nonexclusive factors the IRS considers in determining whether equitable relief is appropriate.

Judicial Review

Taxpayers seeking relief under IRC § 6015 generally file Form 8857, *Request for Innocent Spouse Relief*, to make the election. After reviewing the request, the IRS issues a notice of determination granting or denying relief. The taxpayer has 90 days from the date the IRS mails the notice to file a petition with the United States Tax Court.[3] If the taxpayer does not receive a determination within six months of filing Form 8857, he or she may petition the Tax Court any time after the six month period.[4] A taxpayer may also raise relief from joint and several liability in a Collection Due Process proceeding,[5] a deficiency proceeding,[6] or a refund suit.

ANALYSIS OF LITIGATED CASES

We analyzed 45 opinions issued between June 1, 2004, and May 31, 2005. Forty-two cases were decided in the Tax Court, two were decided in United States Courts of Appeals,[7] and one was decided in United States district court.[8] Of the 45 cases, 33 were decided in favor of the IRS, 11 in favor of the taxpayer, and one was a split decision.[9] See Table 8 in Appendix 3 for a detailed breakdown of the decided cases.

While the courts considered many factors in determining the appropriateness of relief under IRC § 6015, the most significant was whether the requesting taxpayer had actual or constructive knowledge of the tax deficiency. All three avenues for relief contain a knowledge element making it the linchpin in most of the courts' analyses.[10] As such, taxpayers generally were not successful if they could not show a lack of actual or constructive knowledge in § 6015(b) or (f) cases.[11] In § 6015(c) cases, the IRS has the burden of prov-

[3] IRC § 6015(e)(1)(A)(ii).

[4] IRC § 6015(e)(1)(A)(i)(II).

[5] IRC § 6320(c); § 6330(c)(2)(A)(i).

[6] *Corson v. Comm'r*, 114 T.C. 354, 363 (2000).

[7] *Alt v. Comm'r*, 93 A.F.T.R.2d (RIA) 2561 (6th Cir. 2004), cert. denied, 125 S. Ct. 606 (Nov. 29, 2004) (affirming Tax Court's decision not to grant relief under IRC §§ 6015(b) and 6015(f) because petitioner failed to show it would be inequitable to hold her liable for the tax deficiency); *Pless v. Comm'r*, 111 Fed. Appx. 178 (4th Cir. 2004) (affirming Tax Court's decision not to grant relief under IRC § 6015(f) because petitioner failed to present evidence supporting her claim despite several opportunities to do so).

[8] *U.S. v. Haag*, 94 A.F.T.R.2d (RIA) 6665 (D, Mass. 2004) (granting the IRS's motion for partial summary judgment on the grounds that petitioner failed to meet two year filing requirement).

[9] The phrase "split decision" refers to cases where the IRS and the taxpayer prevailed in one or more aspects of the disputed issues. The split decision was *Levy v. Comm'r*, T.C. Memo. 2005-92 (granting relief for petitioner's 1979, 1991–1995 tax deficiencies, and denying relief for petitioner's 1996–1999 tax deficiencies).

[10] Taxpayer must establish he or she did not know, or have reason to know, of the deficiency. IRC § 6015(b)(1)(C); election not valid if the IRS can show the taxpayer had actual knowledge of the item giving rise to the deficiency. IRC § 6015(c)(3)(C); IRS will grant relief if the requesting taxpayer had no knowledge or reason to know nonrequesting taxpayer would not pay tax liability. Rev. Proc. 2003-61 § 4.02(1)(b). Knowledge or reason to know of the deficiency weighs against the requesting taxpayer in the "facts and circumstances test." Rev. Proc. 2003-61, § 4.03(2)(a)(iii).

[11] Rev. Proc. 2003-61 modifies Rev. Proc. 2000-15 to reduce the weight given to the knowledge or reason to know factor in section 6015(f) determinations. Rev. Proc. 2003-61, § 3.02.

ing actual knowledge. The IRS lost in four of 14 cases where the government failed to carry its burden of proof as to "actual knowledge" under IRC § 6015(c)(3)(C).

Taxpayers were often unrepresented in joint and several liability cases. Sixty percent (27 of 45) of the taxpayers litigated cases without the assistance of legal representation, *i.e., pro se*. IRC § 6015(e)(4) directs the Tax Court to establish rules providing the nonrequesting spouse with adequate notice and an opportunity to intervene in the case.[12] The nonrequesting spouse intervened in approximately 18 percent of the cases (eight out of 45). Intervention may lead to longer and more expensive litigation, especially when IRS has conceded the issue of relief.[13]

Most of the decided cases were resolved on factual determinations involving knowledge, economic hardship, or whether it would be inequitable to hold the requesting spouse liable for the tax. Over one-half of the cases turned on the factor analysis in Rev. Proc. 2003-61 or its predecessor, Rev. Proc. 2000-15. The Tax Court issued four precedential opinions involving procedural legal issues.

McGee v. Commissioner

To be timely, a requesting spouse must elect relief from joint and several liability no later than two years from the date of the IRS's first collection activity against the requesting spouse.[14] The IRS's offset of a refund against an existing tax assessment under § 6402 is a collection activity that triggers the two-year period.[15] In *McGee v. Commissioner*, the IRS denied the requesting spouse's claim for relief under IRC § 6015(f) solely on the basis that the claim was filed more than two years after the refund offset. The Tax Court concluded that the refund offset notice was a "collection-related" notice and that the IRS's failure to provide the requesting spouse with adequate notice of the right to file a claim for relief under § 6015 violated § 3501(b)[16] of the Internal Revenue Service Restructuring and Reform Act of 1998, resulting in prejudice to the spouse. The Tax Court held that the two-year rule did not start to run and that the requesting spouse's claim was timely.[17] In response, to the opinion, the IRS added language in 2005 to Publication 1, Your Rights As A Taxpayer, informing taxpayers that a refund offset could start the two-year period and revised the refund offset notices to inform taxpayers of the two-year rule and the taxpayer's right to file an innocent spouse claim. [18] The IRS also issued a notice directing

[12] Tax Ct. R. 325.

[13] *Coleman v. Comm'r*, T.C. Summ. Op. 2004-165 (IRS had conceded relief; Tax Court sustained relief despite intervenor's objection).

[14] IRC § 6015(b)(1)(E); IRC § 6015(c)(3)(B); Rev. Proc. 2003-61, §§ 4.01(3)and (5); Treas. Reg. § 1.6015-5(b)(1).

[15] *Campbell v. Comm'r*, 121 T.C. 290 (2003).

[16] Section 3501(b) provides that the Secretary must provide notice of an individual's right to elect relief from joint and several liability in Publication 1 and in any "collection-related notices."

[17] *McGee v. Comm'r*, 123 T.C. 314 (2004).

[18] IRS Pub. 1, *Your Rights As A Taxpayer* (May 2005).

counsel and IRS employees to no longer raise the timeliness issue unless the facts are distinguishable from *McGee*.[19]

Van Arsdalen v. Commissioner

Tax Court Rule 325 provides procedures for nonrequesting spouses to intervene in a § 6015 Tax Court proceeding. Pursuant to those rules, the IRS served notice on Ms. Van Arsdalen's former spouse, Mr. Murray, of his right to intervene in the case for the *sole purpose of challenging* Ms. Van Arsdalen's right to § 6015 relief. Mr. Murray filed a notice of intervention and expressed his intent to intervene for the sole purpose of *supporting* his former wife's right to relief. The Tax Court granted Ms. Van Arsdalen's motion to strike the notice because it unnecessarily restricted Mr. Murray's right to intervene. The Tax Court explained that neither the statute nor the Tax Court rules restricted the right of intervention.[20] The IRS revised the notice of filing that it serves on intervenors to be consistent with the court's holding by deleting the restrictive language.[21]

Drake v. Commissioner

The taxpayer filed a bankruptcy petition in September 2003. In January 2004, the IRS issued a notice of determination to the taxpayer denying her claim for relief under § 6015, and she timely filed a petition in Tax Court to challenge the determination. The Tax Court granted the IRS's motion to dismiss for lack of jurisdiction because the taxpayer filed her petition in violation of the automatic stay imposed by the Bankruptcy Code. The Tax Court noted that Congress did not include a tolling provision in § 6015 comparable to IRC § 6213(f), which would permit a taxpayer to file a petition for redetermination with the Tax Court after the automatic stay is no longer in effect.[22] The National Taxpayer Advocate recommended a legislative change in the 2004 Annual Report[23] to fix this unintended result.

Friday v. Commissioner

The IRS issued a notice of determination denying the taxpayer's claim for relief under § 6015 because it was untimely, and the taxpayer filed a petition in Tax Court to challenge the determination. Following the *McGee* opinion, the IRS filed a motion to remand the case back to IRS for a determination on the merits with respect to the taxpayer's claim for relief. The Tax Court denied the IRS's motion providing that if more time is needed to make a determination, the IRS should request a continuance. The Tax Court stated that it does remand CDP cases because the Commissioner retains jurisdiction under IRC § 6330(d)(2), but pointed out that § 6015 does not contain a parallel provision.[24] The

[19] CC Notice, 2005-010 (May 20, 2005).

[20] *Van Arsdalen v. Comm'r*, 123 T.C. 135 (2004).

[21] CC Notice 2005-011, Q&A 6 (May 20, 2005).

[22] *Drake v. Comm'r*, 123 T.C. 320 (2004).

[23] National Taxpayer Advocate 2004 Annual Report to Congress 490.

[24] *Friday v. Comm'r*, 124 T.C. 220 (2005).

Commissioner no longer files motions to remand.[25]

CONCLUSION

Joint and several liability under IRC § 6015 remains a highly litigated issue. Most of the cases are resolved on factual determinations of knowledge, reason to know, and hardship. Taxpayers' success or failure often turns on their willingness and ability to provide documentation. The Tax Court continues to resolve procedural issues requiring the IRS to modify its procedures in response to the court's rulings.

[25] CC Notice 2005-011, Q&A 30 (May 20, 2005)

LITIGATED

ISSUE #9 SUMMONS ENFORCEMENT UNDER INTERNAL REVENUE CODE SECTION 7604

SUMMARY

We reviewed 44 federal court opinions on issues related to IRS summons enforcement during the 12 months from June 1, 2004, through May 31, 2005.[1] The IRS has the authority to summon the production of books, records or testimony from witnesses when investigating either a civil or criminal tax liability.[2] This information can be obtained from the person who is the subject of the investigation by serving a summons directly on that person.[3] The IRS can also obtain this information from third-party record keepers who are holding records relating to that person by serving summonses upon those record keepers and providing notice of the summons to the person identified in the summons.[4]

When a summons is served upon the person who is the subject of the investigation, that person may contest the legality of the summons by waiting until the IRS brings a proceeding to enforce the summons and raising appropriate arguments at that time.[5] When a summons is served upon a third-party record keeper, a person identified in the summons can challenge the legality of a summons by intervening in a proceeding or by bringing a proceeding to quash the summons.[6] Generally, the burden on the IRS to demonstrate the validity of the summons is minimal and the burden upon the taxpayer to demonstrate the illegality of the summons is formidable.[7] The taxpayer prevailed in whole or in part in only two of the 44 cases.[8]

1 A summons is a document notifying the person to whom it is directed that he must appear on the day designated and answer claims or give testimony or produce certain books, papers or other data. *Albachten v. Corbett*, 156 F. Supp. 863 (S.D. Cal. 1957).

2 IRC § 7602; Treas. Reg. § 301.7602-1.

3 IRC §§ 7602(a) and 7603(a).

4 IRC §§ 7603(b) and 7609(a).

5 *Schulz v. IRS*, 395 F.3d 463 (2nd Cir. 2005), clarified by *Schulz v. IRS*, 413 F.3d 297 (2nd Cir. 2005 (clarifying that the initial second circuit opinion did not prohibit pre-hearing attachments).

6 IRC § 7609(a) requires that anyone identified in a third-party summons (other than the person summoned) must be given notice of the summons. IRC § 7609(b) provides that those persons who are entitled to notice can intervene in a proceeding regarding the summons and can initiate a proceeding to quash the summons.

7 The burden upon the government is slight for the statute must be read broadly in order to ensure that the enforcement powers of the IRS are not unduly restricted. *U.S. v. Judicial Watch, Inc.*, 371 F.3d 824 (D.C. Cir. 2004).

8 *Doe v. U.S.*, 398 F.3d 686 (5th Cir. 2005), *rev'g Doe v. KPMG, L.L.P.*, 93 A.F.T.R.2d (RIA) 1808 (N.D. Tex. 2004) (reversing U.S. district court ruling that applied equitable tolling doctrine to extend statute of limitations for assessment while summons was litigated); *U.S. v. BDO Seidman, LLP*, 94 A.F.T.R.2d (RIA) 5066 (N.D. Ill. 2004); *U.S. v. BDO Seidman, LLP*, 95 A.F.T.R.2d (RIA) 1725 (N.D. Ill. 2005); *U.S. v. BDO Seidman*, 368 F.Supp.2d 858 (N.D. Ill. 2005) (one case, three opinions issued involving the attorney-client privilege and exceptions to that privilege.).

PRESENT LAW

The IRS has broad authority under IRC § 7602 to issue summonses for the examination of a taxpayer's books and records or to direct testimony under oath.[9] The IRS has the authority to enforce a summons under IRC § 7604 by bringing suit in the appropriate United States district court. The IRS also has the authority to obtain information related to an investigation from third-party record keepers pursuant to IRC § 7609, provided that notice is given to those identified in the summons so that they have the opportunity to contest the summons. A summons can be contested on the grounds that the IRS has failed to satisfy the threshold requirements for issuing a summons, as set forth by the Supreme Court in *United States v. Powell*:

- The investigation must be conducted for a legitimate purpose;
- The inquiry must be relevant to that purpose;
- The IRS must not already possess the information; and
- All required administrative steps must have been taken.[10]

The IRS initially has the burden in a summons enforcement proceeding to show that the *Powell* requirements are satisfied. The burden shifts to the person attempting to quash the summons to demonstrate the *Powell* requirements were not met or that enforcement of the summons would be an abuse of process.[11] The IRS's burden in satisfying the *Powell* requirements is minimal, while the taxpayer's burden to demonstrate that one of the factors has not been satisfied is heavy.[12]

There are other limitations on the issuance of a summons, including the restriction against issuing summons *after* an IRS recommendation to the Department of Justice for criminal prosecution.[13] Additionally, the IRS may not obtain information protected by a statutory or common law privilege, such as:

- Attorney-client privilege;[14]
- Work product privilege;[15] or

[9] *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 816 (1984) (stating, "In order to encourage effective tax investigations, Congress has endowed the IRS with expansive information-gathering authority . . ..")

[10] *United States v. Powell*, 379 U.S. 48, 58-59 (1964).

[11] *La Mura v. U.S.*, 765 F.2d 974, 979 (11th Cir. 1985).

[12] The IRS burden can generally be satisfied by presenting the sworn affidavit of the agent who issued the summons attesting to the necessary facts. *Id.*

[13] IRC § 7602(d)(1).

[14] The attorney-client privilege generally provides protection from discovery of information where: (1) legal advice of any kind is sought, (2) from a professional legal advisor in his or her capacity as such, (3) the communication is related to this purpose, (4) made in confidence, (5) by the client, (6) and at the client's insistence protected, (7) from disclosure by the client or the legal advisor, (8) except where the privilege is waived. *U.S. v. Evans*, 113 F.3d 1457 (7th Cir. 1997), *citing* John Henry Wigmore, Evidence in Trials at Common Law § 2292 (John T. McNaughten rev. 1961).

[15] The work product doctrine protects against the discovery of documents and other tangible things prepared in anticipation of litigation. *U.S. v. BDO Seidman*, LLP, 95 A.F.T.R.2d (RIA) 1725 (N.D. Ill. 2005).

- Tax practitioner privilege.[16]

There are limitations to these privileges. For example, these privileges extend to "tax advice" but not to tax return preparation materials.[17] Additionally, the identities of clients are not generally considered privileged information, except in rare cases where so much of the actual confidential communication has been disclosed such that merely identifying the client would effectively disclose that communication.[18] Another limitation is the so-called "crime-fraud" exception that permits discovery of communications between an attorney and client that are in furtherance or perpetration of a fraud.[19]

When the IRS serves a summons on a third-party record keeper, the IRS is required to give notice of the summons to any person who is identified in the description of the books and records contained in the summons in order that such person can contest the summons.[20] Notice must be provided to the person within three days of the day on which the summons is served to the record keeper, but no later than the 23rd day before the day fixed on the summons on which the records will be reviewed.[21] Persons entitled to notice under IRC § 7609(a)(2) may bring a proceeding to quash a third-party record keeper summons in the appropriate federal district court. These proceedings must be brought within 20 days after notice of the summons is served.[22] Summonses issued "in aid of collection" of an assessed liability or judgment rendered against a person whose liability is at issue are generally exempt from IRC § 7609 notice procedures.[23] In other words, the IRS is not required to give notice to persons identified in the summons where the purpose of the summons is to aid the collection of a liability. However, the courts have interpreted the "aid of collection" exception to apply only where the taxpayer, upon whose liability the summons is issued, owns a legally identifiable interest in the account or other property for which records are summoned.[24]

ANALYSIS OF LITIGATED CASES

This is the first year that summons enforcement appears in the National Taxpayer Advocate's Annual Report to Congress as a Most Litigated Issue. A detailed listing of this

16 IRC § 7525 extends the protection of the common law attorney-client privilege to tax practitioners. Criminal tax matters and communications regarding tax shelters are exceptions to the privilege. IRC § 7525 (a)(2) and (b). The tax practitioner privilege is interpreted based on the common law rules of the attorney-client privilege. *U.S. v. BDO Seidman*, LLP, 337 F.3d 802, 810-812 (7th Cir. 2003).

17 *U.S. v. Frederick*, 182 F.3d 496 (7th Cir. 1999).

18 *BDO Seidman* at 811.

19 *U.S. v. Zolin*, 491 U.S. 554 (1989).

20 IRC § 7609(a); Treas. Reg. § 301.7609-3(a); *see also Ip v. U.S.*, 205 F.3d 1168,1172 (9th Cir. 2000) (stating "The purpose of the notice provision is to allow people to assert defenses, such as attorney-client privilege or relevancy objects, that would be unavailable to them in the absence of notice.")

21 IRC § 7609(a)(1).

22 IRC § 7609(b)(2)(A).

23 IRC §7609(c)(2)(D); Treas. Reg. § 301.7609-4(a).

24 *Ip v. U.S.*, 205 F.3d 1168,1172-1176 (9th Cir. 2000).

year's cases can be found in Table 9 in Appendix 3. Summons enforcement is the primary issue in all of these cases. The court ruled in favor of the IRS in 42 of the 44 cases, while a taxpayer prevailed in one case and another ended in a split decision. Attorneys represented taxpayers in 24 cases, while 20 taxpayers were *pro se (i.e.*, without counsel). Arguments raised by litigants against the IRS summons generally fell into the following categories:

- ***Powell* Requirements:** None of the litigants prevailed when attacking IRS summonses based on satisfaction of the *Powell* requirements. The burden on the IRS is "slight" while the burden on those challenging the summons is significant.[25] Courts found that revenue agents' questionable comments were not sufficient to prove improper purpose by the agency or those with authority to initiate the audit.[26] Likewise, the IRS defeated a taxpayer's claim that the IRS already possessed the information by providing an affidavit to the contrary from the agent who issued the summons.[27] Taxpayers were also unsuccessful when disputing the relevance of the documents to the investigation.[28]
- **Notice:** The issue of insufficient notice was raised by taxpayers in several cases in an attempt to invalidate summonses.[29] Additionally, because entitlement to notice confers standing to challenge a summons under IRC § 7609(b), the IRS also raised entitlement to notice as a means to argue that litigants did not have standing to contest the summons.[30] The notice requirements for a summons issued in aid of collection of a tax liability were addressed in *Cranford v. U.S.*[31] Generally, the IRS is not required to give notice of a summons in aid of collection, provided that the taxpayer who is the subject of the investigation has a legally significant interest in the account or other property for which records are sought.[32] The United States district court ruled in *Cranford* that the IRS was not required to give the taxpayer's spouse notice of the summons because the summons was in aid of the collection of her husband's tax liability and her husband had a legally identifiable interest in the credit card account.[33]

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25 *U.S. v. Kis*, 658 F.2d 526 (7th Cir. 1981)

26 *U.S. v. Judicial Watch, Inc.*, 371 F.3d 824, 829-830 (D.C. Cir. 2004).

27 *Xelan v. U.S.*, 361 F.Supp.2d 459, 465-466 (D. Md. 2005).

28 *U.S. v. Monumental Life Insurance Co.*, 345 F.Supp.2d 712 (W.D. Ky. 2004); *Grenier v. U.S.*, 94 A.F.T.R.2d (RIA) 7116 (D. N.D. 2004);

29 *Conner v. U.S.*, 94 A.F.T.R.2d (RIA) 5794 (W.D. Va. 2004) (holding that although the date of the notice was in dispute, even if the notice was one day late, the taxpayer was not prejudiced); *Xelan, Inc. v. U.S.*, 94 A.F.T.R.2d (RIA) 6755 (E.D. Pa. 2004) (holding that IRS is not required to give notice to all people who might be referenced on summoned records).

30 *Thompson-Perry v. U.S.*, 94 A.F.T.R.2d (RIA) 6862 (N.D. Ohio 2004) (holding that taxpayer did not have standing to file suit because the summons was issued in "aid of collection" and was exempt from IRC § 7609 notice requirements).

31 *Cranford v. U.S.*, 359 F.Supp.2d 981.

32 *Ip v. U.S.*, 205 F.3d 1168,1176 (9th Cir. 2000).

33 *Cranford v. U.S.*, 359 F.Supp.2d at 988.

- **Criminal Referral:** Taxpayers also raised IRC § 7602(d) in order to invalidate summonses where taxpayers perceived an impending referral to the Department of Justice for criminal prosecution.[34] The IRS is prohibited from issuing a summons or beginning an enforcement proceeding on a summons if a referral to the Department of Justice is in effect.[35] Courts generally accept the testimony of the IRS agent who issued the summons that no criminal referral has been made, unless the person contesting the summons can provide direct evidence to the contrary.[36]
- **Constitutional Arguments:** Taxpayers also unsuccessfully raised constitutional arguments.[37] Courts noted that First Amendment rights can be implicated by IRS summonses if it can be demonstrated that the IRS will subsequently take action with the information that may "chill" free speech rights. Taxpayers also claimed that summonses were too broad in violation of the Fourth Amendment's restrictions against unreasonable searches and seizures; however, the courts ruled a summons is not overly broad for constitutional purposes if it is reasonably relevant to the IRS's inquiry.[38] Additionally, taxpayers raised Fifth Amendment protections. Although the Fifth Amendment privilege may be applicable in summons cases, it is inapplicable where the summons seeks only non-testimonial data.[39]
- **Privilege and Equitable Estoppel:** The only two arguments to prevail against the IRS in the summons litigation cases was the assertion of privilege as a bar to disclo-

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34 *U.S. v. Xelan, Inc.*, 96 A.F.T.R.2d (RIA) 5217 (S.D. Iowa 2005) (holding that agent's affidavit that no referral had been made to the Department of Justice is sufficient to override plaintiff's concerns that a grand jury subpoena was issued to one of the plaintiff's entities); *U.S. v. Pate*, 94 A.F.T.R.2d (RIA) 5480 (5th Cir. 2004) (holding that summons is enforceable unless taxpayer can demonstrate that the sole purpose in issuing the subpoena is related to the criminal investigation); *U.S. v. Hayden*, 358 F.Supp.2d 951 (S.D. CA 2004) (holding IRC § 7602(b) allows IRS to investigate for "any offense" and matter was not referred to Department of Justice); *Ryerson v. IRS*, 371 F.Supp.2d 1130 (D. AZ 2005) (holding that testimony of agent that no referral had been made is sufficient).

35 IRC § 7602(d).

36 *Ryerson v. IRS*, 371 F.Supp.2d 1130 (D. Ariz. 2005) (holding that testimony of agent that no referral had been made is sufficient where plaintiff offered no evidence to the contrary). *U.S. v. Norwood*, 343 F.Supp.2d 869 (D. N.D. 2004) (holding mere suspicion of future criminal prosecution is insufficient to invalidate summons).

37 *U.S. v. Heubusch*, 95 A.F.T.R.2d (RIA) 1066 (2nd Cir. 2005) (holding documents suppressed in criminal case can be summonsed in civil case without violating the Fourth Amendment's prohibition against unreasonable searches and seizures if there was an independent source for discovering the information, as there was in this case); *U.S. v. Judicial Watch*, 371 F.3d 824 (D.C. Cir. 2004) (holding (1) there was no evidence that audit and summons were retaliatory or that the request for names of donors contributing more than $3,000 would chill donors' rights to free speech under the first amendment; (2) summons was not so overbroad as to violate the Fourth Amendment; and (3) neither the audit or summons was a selective "prosecution" or retaliatory, therefore, the Fifth Amendment was not violated) *U.S. v. B & D Vending, Inc.*, 398 F.3d 728 (6th Cir. 2004) (holding that discovery of corporate documents does not raise Fifth Amendment issues of owner of the corporation); *Ryerson v. IRS*, 371 F.Supp.2d 1130 (D. AZ 2005) (holding that while discovery of documentary evidence may be unpleasant for taxpayer, such discovery does not raise Fifth Amendment issues).

38 *Judicial Watch*, 371 F3d at 831-32.

39 *U.S. v. Olmer*, 94 A.F.T.R.2d (RIA) 6482 (D. Neb. 2004) (stating that the fifth amendment privilege is inapplicable to summonses seeking non-testimonial data, such as copyrighted names.

sure of the summoned information and a lower court's improper use of the doctrine of equitable estoppel to extend the statute of limitations.[40] In the case where the taxpayer prevailed and the split decision, there was a history of prolonged litigation in other cases between the same parties (*i.e.* the IRS, various tax consultants and their clients) over the marketing and use of tax shelters, involving thousands of contested documents.[41] The IRS prevailed in much of this litigation, particularly where the taxpayers or their consultants asserted that the identities of taxpayers were within the attorney-client or tax practitioner privilege.[42] However, courts continued to restrict IRS summons enforcement where the documents sought evidenced an intent to seek legal advice from counsel or other tax practitioners, provided that the privilege had not been waived.[43] The Fifth Circuit refused to apply the doctrine of equitable estoppel to extend the statute of limitations on assessment during summons litigation, reversing the district court's application of that doctrine.[44]

CONCLUSION

The IRS may issue a summons to obtain information needed to determine the correctness of a return, determine if a tax return should have been filed, determine a taxpayer's tax liability, or to collect a taxpayer's liability.[45] For these purposes, the IRS may summons documentation from taxpayers who have failed to voluntarily provide that information to the IRS. As the cases demonstrate, the summons authority is also useful in uncovering the identities of taxpayers who participate in fraudulent schemes. In at least nine of the cases reviewed, the summons in question was issued to third-parties who the IRS believed were marketing unlawful tax shelters to taxpayers, reflecting the IRS's increased attention

[40] *U.S. v. BDO Seidman*, LLP, 95 A.F.T.R.2d (RIA) 1725 (N.D. Ill. 2005) (holding after *in camera* review that all but one of the documents reviewed were privileged attorney-client communications); *U.S. v. BDO Seidman*, 368 F.Supp.2d 858 (N.D. Ill. 2005) (holding attorney-client communications were not waived when counsel memorandum was allegedly faxed to a law firm experiencing similar legal issues with the IRS).; *Doe v. U.S.*, 398 F.3d 686 (5th Cir. 2005) (reversing a district court's holding that the statute of limitations on assessment is equitably tolled during summons litigation).

[41] *U.S. v. BDO Seidman*, LLP, 337 F.3d 802, 810-812 (7th Cir. 2003); *U.S. v. BDO Seidman*, LLP, 95 A.F.T.R.2d (RIA) 1725 (N.D. Ill. 2005); *U.S. v. BDO Seidman*, 368 F.Supp.2d 858 (N.D. Ill. 2005); *Doe v. KPMG, LLP*, 398 F.3d 686 (5th Cir. 2005); see also *U.S. v. Arthur Andersen*, LLP, 273 F.Supp.2d 955 (N.D. Ill. 2003), amended on reconsideration, *U.S. v. Arthur Anderson*, LLP, 92 A.F.T.R.2d (RIA) 5800 (N.D. Ill. 2003).

[42] *U.S. v. BDO Seidman*, LLP, 337 F.3d 802 (7th Cir. 2003).

[43] *BDO Seidman, LLP*, 95 A.F.T.R.2d (RIA) 1725 (N.D. Ill. 2005) (holding that "no warranty" language in consulting agreement did not result in a waiver of attorney-client privilege).

[44] *Doe v. U.S.*, 398 F.3d 686 (5th Cir. 2005) equitable tolling, assessed against the taxpayer, suspends the statute of limitations because the taxpayer acted with unclean hands; for example, taxpayer intentionally shielding their identity from the IRS until the statute of limitations expires.

[45] IRC § 7602(a).

to shelter activity.[46] As the IRS becomes more aggressive in its enforcement initiatives, it is likely it will make increased use of the summons enforcement tool, and the courts will continue to see increased numbers of these cases.

46 *Doe v. U.S.*, 398 F.3d 686 (5th Cir. 2005); *U.S. v. BDO Seidman*, 95 A.F.T.R.2d (RIA) 2090 (E.D. Il. 2005); *U.S. v. BDO Seidman*, 95 A.F.T.R.2d (RIA) 1725 (N.D. Ill. 2005); *Xelan, Inc v. U.S.*, 94 A.F.T.R.2d (RIA) 6755 (E.D. Pa. 2004); *Xelan, Inc v. U.S.*, 361 F.Supp.2d 459 (D. Md. 2005); *Xelan, Inc v. U.S.*, 94 A.F.T.R.2d (RIA) 5217 (S.D. Iowa 2004); *Estate of Reiserer v. U.S.*, 95 A.F.T.R.2d (RIA) 2660 (W.D. Wash 2005); *Domestic Executive Leasing Services, LLC, v. U.S.*, 95 A.F.T.R.2d (RIA) 1966 (D. Nev. 2005); *U.S. v. Kaiser*, 397 F.3d 641 (8th Cir. 2005).

LITIGATED ISSUE #10 TRUST FUND RECOVERY PENALTY UNDER INTERNAL REVENUE CODE SECTION 6672

SUMMARY

The Trust Fund Recovery Penalty under Internal Revenue Code § 6672 is a means by which the government holds certain persons responsible for willfully failing to withhold or remit the trust fund portion of payroll taxes.[1] When a person is deemed a "responsible person" under the statute, the IRS assesses a civil penalty equal to 100 percent of the trust fund portion of the payroll taxes that were not remitted.[2] Whether a person actually had the responsibility to withhold payroll taxes and whether he or she willfully failed to do so are mixed questions of law and fact that are frequently litigated in United States district courts, bankruptcy courts, and the Court of Federal Claims.

PRESENT LAW

To be liable for the Trust Fund Recovery Penalty (TFRP), a person must be responsible for withholding and remitting taxes and have willfully avoided paying those taxes.[3] Thus, to obtain relief from the TFRP, a taxpayer must either demonstrate that he or she was not a "responsible person" or did not act "willfully" within the meaning of IRC § 6672.

Responsible Person

The determination of whether one is a responsible person within the meaning of IRC § 6672 is a matter of status, duty, and authority, as evidenced by:

- Holding of a corporate office;
- Control over financial affairs;
- The authority to disburse corporate funds; or
- The ability to hire and fire employees.[4]

A "responsible person" is someone with significant (not necessarily exclusive) control over the company's finances.[5] In general, the IRS will not seek to assess the penalty against non-owner employees of the business entity who act solely under the control of others and are not in a position to act independently of others.[6] On the other hand, instructions from a superior to not pay taxes do not immunize a person otherwise responsible under

[1] IRC §§ 3102 and 3402(a) require employers to withhold certain Social Security and income taxes from employees' wages. IRC § 7501 provides that taxes withheld from others, which are to be paid to the United States, are held in a special fund in trust for the United States. Thus, these amounts are referred to as the "trust fund" portion of payroll taxes. The IRS is required to credit the employees for the withheld taxes even if the employer fails to remit them. *Slodov v. United States*, 436 U.S. 238 (1978).

[2] IRC § 6672.

[3] *United States v. Carrigan*, 31 F.3d 130, 133-34 (3rd Cir. 1994).

[4] *Thibodeau v. U.S.*, 828 F.2d 1499, 1503 (11th Cir. 1987). When conducting trust fund responsibility interviews with potentially responsible persons, the IRS uses Form 4180 (Report of Interview with Individual Relative to Trust Fund Recovery Penalty) in order to make a determination regarding responsibility.

[5] *United States v. Carrigan*, 31 F.3d 130, 133 (3rd Cir. 1994) (citation omitted).

[6] IRM § 1.2.1.5.14.(3).

the statute.[7] In addition, the term "responsible person" can include corporations and other artificial entities.[8]

Willfulness

To prove willfulness, the IRS must demonstrate that the person had knowledge of the payments to other creditors after he or she was aware that withholding taxes were delinquent and made a voluntary act to prefer one creditor over the United States.[9] While no bad motive needs to be established to prove willfulness, the IRS must at least demonstrate that the taxpayer acted in reckless disregard of whether the taxes were being paid over.[10]

Procedural Issues

The IRS conducts a investigation, including interviewing potentially responsible persons, before making an assessment.[11] The IRS has no obligation to attempt to collect trust fund taxes from the employer before assessing the TFRP penalty against a responsible person.[12] Note, however, that the period in which the IRS must assess the TFRP against a responsible person is the period in which the IRS must assess the employer for the underlying employment tax liability.[13] The responsible person and the IRS may agree to extend the period for assessing the TFRP by executing Form 2750, *Waiver Extending Statutory Period for Assessment of Trust Fund Recovery Penalty*.

Before the IRS can assess the penalty, however, it must send notice to the taxpayer informing him or her of the proposed assessment.[14] In the notice, the IRS encloses Form 2751, Proposed Assessment of Trust Fund Recovery Penalty, setting forth the periods and amounts of the proposed TFRP assessment, and offering the taxpayer an opportunity to appeal the proposed assessment to the Office of Appeals.[15] If the taxpayer and the IRS still cannot agree on the proposed assessment after the Appeals conference, the taxpayer can pay a specified portion of the liability and file a claim for refund in the appropriate

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[7] *Brounstein v. U.S.*, 979 F.2d 952, 955 (3rd Cir. 1992) (citations omitted).

[8] *Pacific Nat'l Ins. Co. v. United States*, 422 F.2d 26, 30 (9th Cir. 1970).

[9] *In re Pugh*, 315 B.R. 889, 898 (D. Nev. 2004); *Phillips v. United States*, 73 F.3d 939, 942 (9th Cir. 1996).

[10] *Phillips v. United States*, 73 F.3d at 942.

[11] IRM § 5.7.6.

[12] The plain language of IRC § 6672 does not require the IRS to try to collect from the employer first.

[13] *Lauckner v. United States*, 68 F.3d 69 (3d Cir. 1995), acq., 1996-2 C.B. 1.

[14] IRC § 6672(b)(1).

[15] *See* IRS Letter 1153.

district court or the Court of Federal Claims.[16] When the government produces a certificate that the penalty assessments for failure to pay withholding taxes were made, the government is entitled to a presumption of correctness in district courts or the Court of Federal Claims, while the person against whom the penalty is assessed bears the burden of proving by a preponderance of the evidence that he or she is not liable.[17] In bankruptcy courts where TFRP issues arise when the IRS seeks to assert its TFRP claim against the debtor's assets, the burden is also on the debtor objecting to the claim to overcome the *prima facie* validity of the creditor's claim.[18]

ANALYSIS OF LITIGATED CASES

We reviewed 34 opinions issued by federal courts in which the TFRP was an issue. Taxpayers prevailed in whole or in part in 13 of the 34 cases, though in three of these cases the court was denying the IRS's motion for summary judgment, thereby requiring the parties to go to trial on the contested issue.[19] A detailed breakdown of TFRP cases appears in Table 10 in Appendix 3.

Of the cases where taxpayers prevailed on the substantive Trust Fund Recovery Penalty issue (thereby disposing of the case in taxpayer's favor), courts relied on three arguments made by taxpayers:

- **Taxpayer Was Not a "Responsible Person":** In three cases, the courts ruled that the taxpayer was not a "responsible person" even though the taxpayer was in a position of authority. In *Dewing v. United States*, for example, the court ruled that a general manager of a casino did not have sufficient control of financial decisions to warrant a responsible person designation.[20] In *Salzillo v. United States*, the Court of Federal

[16] IRC § 6672(c) provides that if the taxpayer makes the required payment within 30 days of notice and demand for payment and files suit within 30 days of the IRS denial of refund, levy action will be stayed until the conclusion of the court proceedings. IRS Letter 1153 instructs taxpayers who wish to contest the IRS assessment that they can appeal the assessment without paying the entire trust fund recovery penalty by: (1) paying the contested payroll tax for at least one employee for each period of liability that the taxpayer wishes to contest; (2) filing a claim for refund for the amounts paid using IRS Form 843, Claim for Refund and Request for Abatement; and (3) posting a bond with the IRS for one and one-half times the amount of the penalty that is left after making the payment for the one employee. As the Trust Fund Recovery cases demonstrate, once the case is filed, the IRS typically counterclaims for the balance of the unpaid liability, thereby placing the entire TFRP liability at issue. *See, e.g., Ashworth v. U.S.*, 95 A.F.T.R.2d (RIA) 2476 (D. N.J. 2005); *Baimbridge v. United States*, 335 F.Supp.2d 1084 (S.D. Cal. 2004); *Gutherie v. United States*, 359 F.Supp.2d 693 (E.D. Tenn. 2005).

[17] *Fidelity Bank v. United States*, 616 F.2d 1181, 1186 (10th Cir. 1980); *Barnett v. United States*, 988 F.2d 1449, 1453 (5th Cir. 1993).

[18] *In re Frank*, 322 B.R. 745 (M.D. N.C. 2005).

[19] *Ashworth v. United States*, 95 A.F.T.R.2d (RIA) 2476 (D. N.J. 2005)(granting summary judgment as to willfulness but question of fact exists as to whether controller was responsible person); *Baimbridge v. United States*, 335 F.Supp.2d 1084 (S.D. Cal. 2004) (question of fact existed about whether installment agreement estopped government from asserting willfulness element of TFRP responsibility); *In re Pugh*, 315 B.R. 889 (D. Nev. 2004)(denying IRS's motion for summary judgment because there was a question of fact about whether corporate officer knew about the withholding taxes had not been paid).

[20] *Dewing v. United States*, 95 A.F.T.R.2d (RIA) 1609 (D. Nev. 2005).

Claims held that the Chief Financial Officer (CFO) was not a responsible person because the president of the company exercised complete dominion over all financial decisions of the company, thereby impairing the CFO's ability to pay the delinquent employment taxes.[21] Thus, the title given to a particular position within a business is not determinative as to responsible person status. In *Secret v. United States*, the IRS pursued an outside accountant for the TFRP, in large part because the accountant had signed Form 4180 *Report of Interview with Individual Relative to Trust Fund Recovery Penalty*, and answered all its questions in the affirmative, indicating he had substantial financial responsibility for the company.[22] The court rejected the IRS's argument that the accountant had admitted liability by virtue of Form 4180, finding:

> Despite the government's unwavering reliance on Secret's Form 4180, the Court finds the document rather unhelpful. The form contains no express admission of responsibility or acknowledgement of liability. It uses vague, undefined terms.[23]

The court found that the preponderance of the evidence established that the accountant did not have true control or authority to take any actions and held that the accountant was not a "responsible person."[24]

- **Taxpayer Did Not Act Willfully.** In several cases, courts ruled that while the taxpayer was a responsible person, the taxpayer had demonstrated that there was no willfulness on his or her part. One taxpayer successfully made this argument by demonstrating he had a good faith belief that all payroll taxes were being paid and that he had instituted dedicated accounts for this purpose.[25] A similar argument, however, was unsuccessful for the president/chief executive officer who hired a surety company to pay the employment taxes when insufficient funds were available. In holding the president/CEO liable for the TFRP, the court concluded that even if the surety company did have some financial responsibility, that fact alone was not dispositive of the president/CEO's liability when he willfully paid other creditors while knowing that employment taxes were due.[26]
- **Bankruptcy Law Precludes IRS Action.** Taxpayers prevailed in two bankruptcy cases with differing arguments about the non-dischargeability of TFRP liabilities.[27] In *United States v. White*, the court concluded that because employment taxes (includ-

[21] *Salzillo v. United States*, 66 Fed. Cl. 23 (2005).

[22] *Secret v. United States*, 373 F.Supp.2d 619 (N.D. W.Va. 2005). Form 4180 asks: Did you: Direct the payment of bills? Make bank deposits? Authorize payroll checks? Prepare federal payroll tax returns? Authorize payment of federal tax deposits? Review federal income tax returns? Determine company financial policy?

[23] *Secret v. United States*, 373 F.Supp.2d at 627.

[24] *Id.* at 629.

[25] *In re Frank*, 322 B.R. 745, 760 (M.D. N.C. 2005) (holding that the taxpayer was not required to follow-up to determine whether these mechanisms were actually utilized by those responsible for making the payments).

[26] *Lencyk v. United States*, 384 F.Supp.2d 1028, 1035 (W.D. Tex. 2005).

[27] TFRP liabilities are not normally discharged in bankruptcy.

ing TFRP liabilities) were nondischargeable, the automatic stay[28] could only be lifted when the case was closed or dismissed. Consequently, the court held that an assessment of the TFRP liability was void when made while the case was in bankruptcy because it violated the automatic stay provisions of the Bankruptcy Code,[29] In contrast, the court in *In re Lowthorp* concluded that the TFRP assessment was discharged because the IRS did not file a proof of claim based on that debt.[30] Consequently, the court determined that the IRS's demands for payment of the TFRP liability were violations of the court's discharge injunction and held the IRS in contempt of court and imposed sanctions.[31]

Taxpayers also were unsuccessful in utilizing certain arguments against the willfulness component of TFRP liability test.

- **Directions of Superiors Affecting Willfulness.** Several taxpayers argued that their omission in failing to pay payroll taxes was due to a superior who instructed them not to pay on the explicit or implied threat of being terminated from employment if the payments were made.[32] This excuse was not successful for any of the taxpayers, with one court labeling it a type of "Nuremberg defense."[33]
- **Agreements with Third Parties Affecting Willfulness.** Several taxpayers argued that the willfulness element of the TFRP liability test could be rebutted by demonstrating an agreement with a third party about how the business's money would be used. In *Underberg v. United States*, the court rejected the argument by the two responsible persons that the company's arrangement with a third party financial services firm, which took control over the company's finances, made it impossible to comply with its tax obligations.[34] An unsympathetic court noted:

> While the dilemma of choosing between losing one's job and violating the nation's tax laws may be a harsh one, corporate officers and directors who face this dilemma are not thereby absolved of responsibility for payment of withholding taxes.[35]

In *Baimbridge v. United States*, the potentially responsible person attempted to address the willfulness component of the TFRP liability test by arguing that the corporation had entered into an installment agreement for the repayment of the delinquent tax, and therefore, the IRS should be estopped from assessing the penalties because it was

28 11 U.S.C.A. § 362(a)(6).

29 *United States v. White*, 325 B.R. 918 (N.D. Ga. 2005).

30 *In re Lowthorp*, 325 B.R. 470 (M.D. Fla. 2005).

31 *In re Lowthorp*, 325 B.R. 470 (M.D. Fla. 2005) *at* 474. See *In re Lowthorp*, 332 B.R. 656 (Bankr. Fla. 2005), for a discussion of the sanctions imposed against the IRS.

32 *Ashworth v. United States*, 95 A.F.T.R.2d (RIA) 2476 (D. N.J. 2005); *In re Borman*, 94 A.F.T.R.2d (RIA) 6301 (Bankr. S.D. Fla. 2004)

33 *In re Borman*, 94 A.F.T.R.2d (RIA) 6301 (Bankr. S.D. Fla. 2004).

34 *Underberg v. United States*, 362 F.Supp.2d 1278, 1288 (D. N.M. 2005).

35 *Id.* at 1287 (citation omitted).

fully aware that the business was going to continue operation and satisfy non-IRS creditors.[36] The court denied the IRS's motion for summary judgment on the issue of willfulness, thereby requiring the parties to go to trial, though the court noted that "binding the government through equitable estoppel is no easy task."[37]

- **Subsequent Cooperation Is Irrelevant to Determination of Willfulness.** In another decision, a district court held that an individual's cooperation after the TFRP assessment was made is irrelevant to the determination of willfulness and held the individual liable for the TFRP, consequently reversing a bankruptcy court decision.[38] The taxpayer was a vice president of the corporation and a shareholder who had check-signing authority, and he paid other creditors in preference to the IRS; thus, he acted willfully and cooperating fully with an IRS revenue officer after receiving a demand for full payment of the past due taxes was irrelevant.[39]

Pro Se Analysis

Only eight out of 34 (or 24 percent) of the taxpayers in these cases were *pro se*, or unrepresented by counsel, and only one unrepresented taxpayer prevailed on the issues raised in litigation. Of the taxpayers who were represented, 12 out of 26 (or 46 percent) prevailed on some or all of the issues. The cases demonstrate that issues related to IRC § 6672 are both procedurally and substantively complex and generally required competent counsel.

CONCLUSION

The TFRP cases reviewed often involved officers of small businesses, such as chief executive officers or chief financial officers, who had some role in determining financial expenditures. Where these officers were also shareholders or investors in the business, the courts had little difficulty in making the requisite "responsible person" and "willfulness" determinations because there appeared to be actual authority and control to make decisions about paying or not paying payroll taxes. However, where the officer was a salaried employee or an outside accountant, the courts struggled with the degree of the person's true level of authority and control. As one court noted, these cases often reflect the difficult choices for corporate officers who are faced with the dilemma in a struggling business between losing one's job or violating the nation's tax laws. Still, these choices do not excuse the responsibility of paying payroll taxes.

[36] *Baimbridge v. United States*, 335 F.Supp.2d 1084 (S.D. Cal. 2004).

[37] *Id.* at 1091.

[38] *United States v. Beltran*, 316 B.R. 371 (S.D. Fla. 2004), *rev'g In re Beltran*, 93 A.F.T.R.2d (RIA) 2303 (Bankr. S.D. Fla. 2003).

[39] *Id.* at 374.

INTRODUCTION

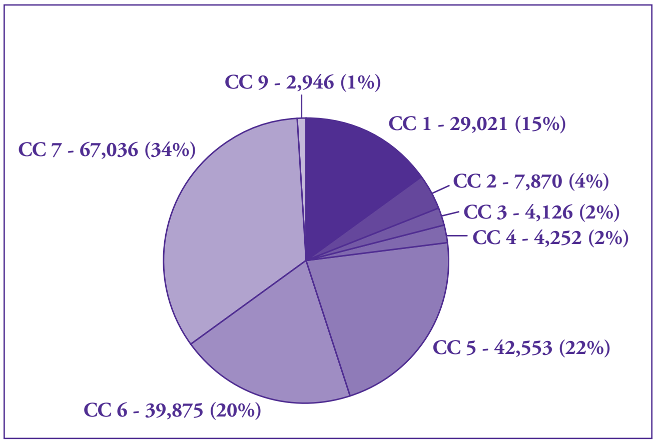
IRC § 7803 requires the National Taxpayer Advocate to report to Congress annually on the activities of the Office of the Taxpayer Advocate.[1] Taxpayer Advocate Service case advocacy work reflects the IRS's operational priorities and workload. Since its "stand up" in 2000, TAS case receipts increasingly reflect the IRS's emphasis on enforcement activities.

CASE ADVOCACY

Case Receipts

IRC § 7811(a) defines the types of hardships taxpayers experience which would meet the criteria for TAS intervention. Chart 4.1 illustrates these receipts by Criteria Code (CC).

CHART 4.1, FY 2005 TAS CASE RECEIPTS BY CRITERIA CODE



1 IRC § 7803(c)(2)(B)(ii)

CHART 4.2, TAS CRITERIA CODES

Economic Burden Case Receipts			
Criteria Code	**Description**	**Number of Cases**	**% of Cases**
CC 1	Taxpayer is suffering or about to suffer a significant hardship (IRC §7811(a)(1)(A))	29,021	15
CC 2	Taxpayer is facing a threat of adverse action (IRC §7811(a)(2)(A))	7,870	4
CC 3	Taxpayer will incur significant costs if relief is not granted (IRC §7811(a)(2)(C))	4,126	2
CC 4	Taxpayer will suffer irreparable injury, or long term adverse impact (IRC §7811(a)(2)(D))	4,252	2
Total Economic Burden Case Receipts		**45,269**	**23%**
Systemic Burden Case Receipts			
Criteria Code	**Description**	**Number of Cases**	**% of Cases**
CC 5	Taxpayer has experienced a delay of more than 30 days to resolve a tax account problem (IRC §7811(a)(2)(B))	42,553	22
CC 6	Taxpayer has not received a response by the date promised	39,875	20
CC 7	A system(s) or procedure(s) has failed to operate as intended or failed to resolve the taxpayer's problem	67,036	34
CC 9	The Local Taxpayer Advocate has determined it is in the best interest of the taxpayer for TAS to be involved	2,946	1
Total Systemic Burden Case Receipts		**152,410**	**77%**
Total Case Receipts		**197,679**	**100%**

IRC § 7803 authorizes the National Taxpayer Advocate to develop guidance for all IRS officers and employees outlining the criteria for referring taxpayer inquiries to TAS.[2] Seven of our criteria fall into two broad taxpayer burden categories: economic burden and systemic burden. TAS also accepts cases where a Local Taxpayer Advocate determines it is in the best interest of the taxpayer for TAS to accept the case into the program. In reviewing our definitions and verification procedures for criteria, we found that in some cases, a few of our requirements for the taxpayer to prove economic harm prior to case acceptance were counterintuitive and caused additional burden. TAS subsequently clarified its case acceptance definitions to include situations:

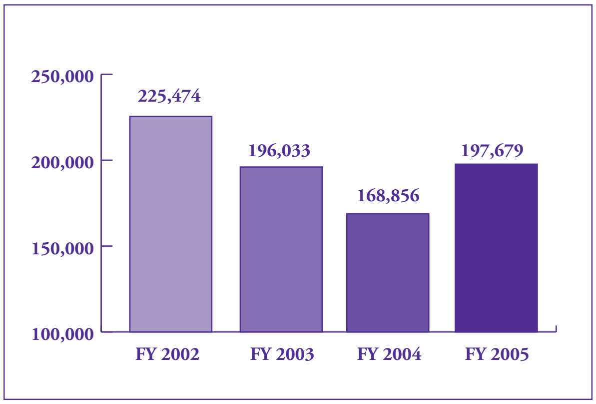
- Where, due to considerations of equity or protection of taxpayer rights, it is in the best interest of the taxpayer to accept his or her case, and
- Where the National Taxpayer Advocate determines that compelling public policy warrants assistance to an individual or group of taxpayers.

Moreover, TAS simplified the verification procedures for economic burden cases. We will implement these clarifications in January 2006.

[2] IRC § 7803(c)(2)(C)(ii).

TAS receipts rose 17 percent in FY 2005 compared to FY 2004. Chart 4.3 illustrates TAS receipts for the last four fiscal years.

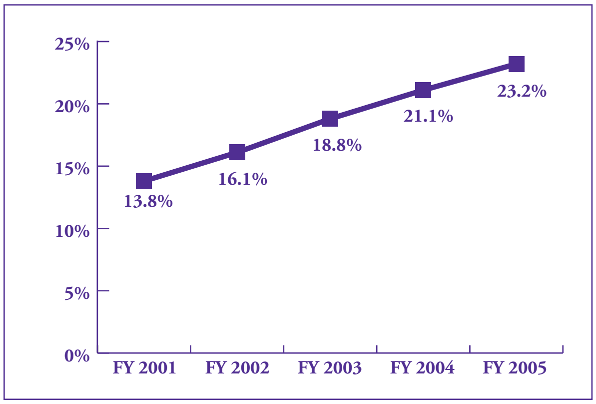
CHART 4.3, TAS RECEIPTS



While TAS receipts rose in the last fiscal year, our staffing has steadily declined over the past several years, from 2,198 staff years in FY 2002 to 1,943 staff years in FY 2005.

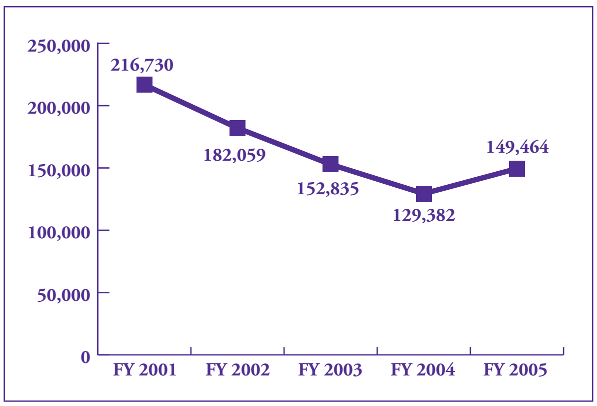
The majority of taxpayers contact TAS because they are experiencing a systemic burden caused by a process, procedure, or system within the IRS that either failed to operate as intended or failed to resolve the taxpayer's problem. In FY 2005, 77 percent of our case receipts met this category, while the remaining 23 percent were the result of taxpayers experiencing some sort of economic burden. The percentage of economic burden cases continues to grow as the IRS increases enforcement and compliance activities and TAS conducts outreach to specific taxpayer populations. Chart 4.4 illustrates the trend of economic burden case receipts over the last four fiscal years.

CHART 4.4, TAS ECONOMIC BURDEN CASE RECEIPTS AS A PERCENTAGE OF TOTAL RECEIPTS



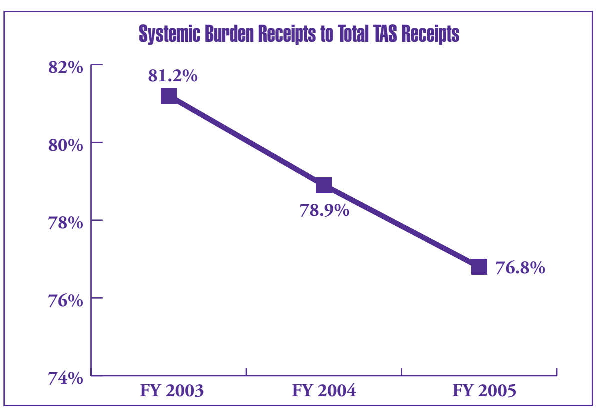
As the chart below illustrates, TAS systemic burden receipts increased 15.5 percent in FY 2005 compared to FY 2004. These cases involve taxpayers experiencing delays of more than 30 days to resolve tax account problems, not receiving responses by the date promised, and systems or procedures failing to operate as intended or failing to resolve the taxpayer's problem. This increase in receipts corresponds to the overall increase in regular case receipts (17 percent) over FY 2004. Increased Criminal Investigation (CI) receipts continue to impact overall TAS receipts. Of the CI receipts, 86.5 percent were attributed to systemic burden.[3]

CHART 4.5, SYSTEMIC BURDEN CASE RECEIPTS



Although TAS systemic burden case receipts increased 15.5 percent over the FY 2004 figure (149,464 versus 129,382), the percentage of systemic burden receipts has steadily declined from 81.2 percent in FY 2003 to 76.8 percent in FY 2005 as illustrated in Chart 4.6.

CHART 4.6, SYSTEMIC BURDEN AND TOTAL TAS CASE RECEIPTS



[3] *See* Most Serious Problem: *Criminal Investigation Refund Freezes, supra.*

Sources of TAS Casework

TAS uses primary and secondary issue codes to identify the issues that lead taxpayers to seek TAS assistance. Table 4.7 illustrates the top 15 case issues received in TAS in FY 2005 based on the taxpayer's primary and secondary issue codes.

TABLE 4.7, TOP 15 ISSUES RECEIVED IN TAS IN FY 2005

Rank	Description of Issue	Number of Cases
1	Criminal Investigation (CI) / Return Preparer Program	31,627
2	Expedite Refund Request	17,775
3	EITC - Revenue Protection Strategy Claims	17,180
4	Processing Amended Return	16,960
5	Levy/Federal Payment Levy Program Levies	13,529
6	Processing Original Return	12,692
7	Audit Reconsideration	9,898
8	Other Refund Inquiries/Issues	7,958
9	Injured Spouse Claim	7,432
10	Closed Underreporter Program	7,205
11	Open Examinations (Non EITC)	6,776
12	Requests for Copies of Returns/Transcripts/Reports or FOIA	6,413
13	Liens	6,199
14	Returned/Stopped Refunds	5,560
15	Failure to File and Failure to Pay Penalties	5,131

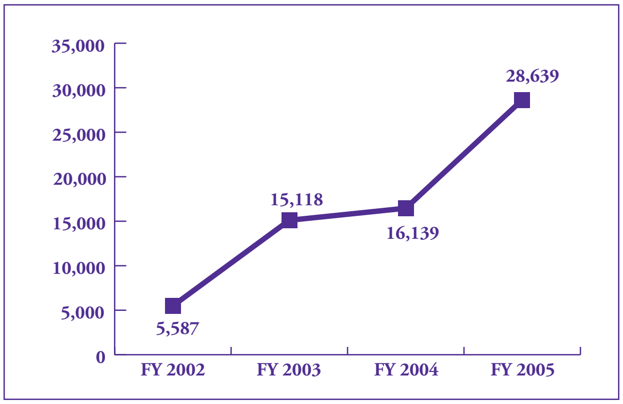
Trends in TAS Case Receipts

TAS case receipts reflect the cause and effect of IRS operational priorities and workload. Increased law enforcement and compliance activities, shifts in the availability and delivery of services to taxpayers, and consolidation and centralization of IRS work processes are apparent in the types of issues that caused taxpayers to seek our assistance in FY 2005.

Criminal Investigation Cases

Since FY 2002, TAS case receipts involving Criminal Investigation (CI) issues have steadily increased as reflected in Chart 4.8.

CHART 4.8, CI RECEIPTS FOR FY 2002 – FY 2005



In both FY 2004 and FY 2005, CI cases comprised the largest portion of TAS receipts.[4] In FY 2005, 28,639 taxpayers contacted TAS because, as a result of CI actions, the IRS failed to issue their refunds or process their returns. This represents a 77.5 percent increase compared to 16,139 cases in FY 2004. The primary programs CI uses to detect and investigate refund fraud are the Questionable Refund Program (QRP) and the Return Preparer Program (RPP).[5] TAS closed 26,206 QRP cases in FY 2005. As illustrated in Table 4.9, TAS obtained full or partial relief for taxpayers in 60 percent of those cases.

TABLE 4.9, DISPOSITION OF CI CASES FOR FY 2005

TYPE OF RELIEF	FY 2005	% TOTAL
RELIEF GIVEN	**15,708**	**60%**
Full relief	14,658	56%
Partial relief	1,050	4%
NO RELIEF	**10,498**	**40%**
TOTAL	**26,206**	**100%**

Lien Issues

In FY 2005, TAS received 6,199 cases where the primary or secondary issue involved a Notice of Federal Tax Lien, compared to 4,329 in FY 2004 and 3,501 in FY 2003. The IRS has centralized routine lien filing and release operations at one campus and reduced the number of field offices that handle the more complex, technical lien issues.

Levy Issues

As the IRS continues to step up its compliance activities, TAS has seen an increase in the number of taxpayers who need our assistance to resolve issues involving lev-

[4] National Taxpayer Advocate 2004 Annual Report to Congress 578.

[5] In May 2005, TAS established a new primary issue code to track RPP cases. As of the end of FY 2005, TAS received 357 RPP cases.

ies, including Federal Payment Levy Program (FPLP) issues. In FY 2005, TAS received 13,529 cases where a levy was the primary or secondary issue compared to 9,019 in FY 2004, representing a 27 percent increase. FPLP levies on Social Security benefits increased 335 percent, from 345 cases in FY 04 to 1,502 in FY 05.[6]

Taxpayer Assistance Center Cases

TAS continues to see an influx of cases related to the level of service available at IRS Taxpayer Assistance Centers (TACs). As these offices eliminate services and reduce hours of operation and staffing, taxpayers are turning to TAS for assistance. To illustrate, we received 6,413 cases in FY 2005 where taxpayers requested copies of returns, forms, or transcripts, which are no longer available through the TACs. This represents an increase of 58 percent from FY 2004, when we received 4,053 such cases. TAS established a special use code in FY 2005 to track the number and nature of cases related to the reduction in services at TACs, and we are closely monitoring this issue.[7]

Case Closures

In FY 2005, TAS closed 190,153 cases received in the past fiscal year or prior years and provided full or partial relief to the taxpayer in 68.14 percent of these cases. FY 2005 case closures increased 11.4 percent over FY 2004, an increase largely attributable to the 17 percent growth in case receipts. Table 4.10 details the disposition of cases closed in FY 2005.

TABLE 4.10, APPLICATION FOR TAXPAYER ASSISTANCE ORDER CASE DISPOSITION

Type of Relief	Number	%
Total Applications for Taxpayer Assistance Closed	**190,153**	**100.00%**
Taxpayer Assistance Orders (TAO) Issued	20	0.01%
Relief provided to taxpayer	**129,560**	**68.14%**
Full relief	119,237	62.71%
Partial relief	10,309	5.42%
TAO issued-BOD (Business Operating Division) /Function complied	12	0.01%
TAO issued-BOD/Function appealed; TAO sustained	1	0.00%
TAO issued-BOD/Function appealed; TAO modified	1	0.00%
No relief provided to taxpayer	**57,133**	**30.05%**
No relief - no response	23,388	12.30%
No relief - Advocate does not deem relief appropriate	18,114	9.53%
No relief - BOD/Function already provided relief	8,584	4.51%
No relief - TP withdraws relief request	2,789	1.47%
No relief - Hardship not substantiated	1,611	0.85%
No relief - no internal revenue law issue	1,391	0.73%
No relief - relief appropriate but law prevents change	1,252	0.66%
TAO issued-BOD/Function appealed; TAO rescinded	4	0.00%
Relief Not Identified	**3,460**	**1.82%**

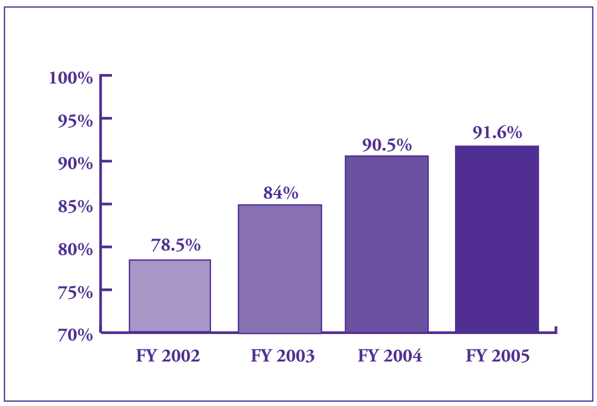
6 *See* Most Serious Problem: *Levies On Social Security Payments, supra.*

7 *See* Most Serious Problem: *Taxpayer Services, supra.*

Case Quality and Timeliness

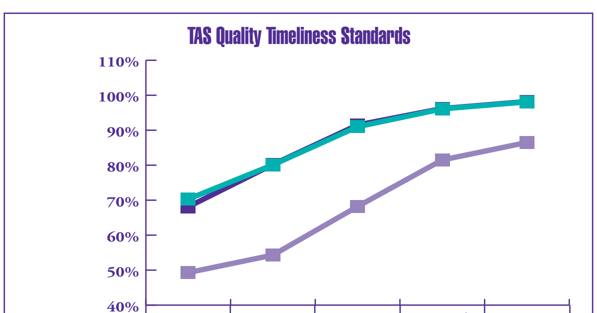
TAS continues to focus on improving case quality, including accuracy, timeliness, and effective communication. The business results, measured by TAS case quality standards, demonstrate continued progress over the last four years, as illustrated in Chart 4.11.[8] At the end of FY 2005, quality stands at 91.6 percent. The goal was 91 percent for FY 2005 and is 91.5 percent for FY 2006.

CHART 4.11, TAS CASE QUALITY FY 2002 THROUGH FY 2005



Timely case action as measured by Quality Standards 1, 2, and 3 continues to improve, as noted in Chart 4.12. During FY 2005, TAS implemented a number of improvement initiatives. Offices now have procedures to monitor critical customer contact dates and have adopted back-up plans for situations when advocates are away from the office. Timely actions positively impact case cycle time and customer satisfaction.

CHART 4.12, TAS QUALITY TIMELINESS STANDARDS



	FY 2002	FY 2002	FY 2003	FY 2004	FY 2005
Std 1 QR	68.1	80.2	91.5	96.2	98.2
Std 2 QR	70.3	80.1	91.0	96.1	98.1
Std 3 QR	49.3	54.3	68.2	81.5	86.5

[8] TAS quality standards are: 1). Did TAS make timely contact with the taxpayer? 2). Did TAS take initial action/request information within the specified period? 3).Did TAS take all subsequent actions timely from the time action could have been taken? 4). Did TAS resolve all taxpayer issues? 5). Did TAS address all related issues? 6). Were all actions taken by TAS and the IRS operations/functional divisions technically and procedurally correct? 7). Did TAS give the taxpayer a clear, complete, correct explanation at closing?

In FY 2005, TAS created specific objectives in support of our strategies and operational priorities, including the ability to identify and respond to taxpayer concerns.

One such objective established standard procedures for reviewing all TAS cases open 100 days or longer.[9] These reviews allow us to gauge compliance with TAS case processing requirements and to ensure case actions are taken at the right time and in the correct manner. The reviews assess whether cases are progressing in a timely and effective way and whether TAS is pursuing appropriate remedies, including issuance of a Taxpayer Assistance Order.

As an adjunct to the 100-Day Case Review Procedures, and in response to findings by the Treasury Inspector General For Tax Administration (TIGTA) in September 2004[10] regarding the timeliness of TAS case processing, we established Early Intervention Guidelines to ensure taxpayer problems are resolved in the most effective and efficient manner. The guidelines require managerial review early on in the case processing cycle to determine whether TAS is pursuing the best approach and taking timely actions. The reviews serve to ensure that the taxpayer's problem is clearly defined and an appropriate plan of action is developed.

Operations Assistance Requests (OARs)

TAS uses Operations Assistance Requests (OARs) to request assistance from an IRS operating division or function to complete an action on a TAS case. An OAR is needed when TAS does not have the statutory or delegated authority to take the action(s) required to resolve the taxpayer's problem. Table 4.13 highlights the OARs issued and closed during FY 2005 and the average number of days it took the IRS to complete the requested action(s).

TABLE 4.13, OAR ACTIVITY FOR FY 2005

Operating Division/Function	OARs Issued	OARs Closed[11]	Average Age (Days)
Appeals	1,879	1,620	69.5
Criminal Investigation	36,341	34,825	23.8
Large/Mid-Size Business	119	89	38.9
Small Business/Self-Employed	61,824	50,805	20.5
Tax Exempt/Government Entities	691	544	31.8
Wage & Investment	61,242	52,680	19.7
Total	**162,096**	**140,563**	**21.6**

[9] TAS established 100-Day Case reviews in FY 2003. The objectives and procedures for conducting the reviews were standardized in the FY 2005 TAS Program Letter.

[10] Treasury Inspector General For Tax Administration, Ref. No. 2004-10-166, *The Taxpayer Advocate Service Needs to Improve Case Management to Ensure Taxpayer Problems are Resolved Timely* (September 2004).

[11] Does not include OARs rejected by the Operating Divisions/Functions due to incomplete or missing information or because they were routed to the wrong area.

Taxpayer Assistance Orders

Internal Revenue Code § 7811 authorizes Local Taxpayer Advocates 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. Upon receipt of a TAO, the responsible IRS official can either agree to take the action requested or appeal the request.

During FY 2005, TAS issued 20 TAOs, compared to 30 in FY 2004. Eleven were Direct TAOs and nine were Review TAOs. The IRS complied with the requested action on twelve TAOs. Three TAOs were rescinded after discussion and negotiation between TAS and the IRS resolved the taxpayers' issues. One TAO was rescinded after new information revealed the taxpayer was not entitled to the requested relief. The IRS appealed two of the TAOs, of which one was sustained and one was modified.

TABLE 4.14, TAXPAYER ASSISTANCE ORDERS ISSUED BY BUSINESS OPERATING DIVISION (BOD)/FUNCTION

Small Business/Self-employed	11
Wage and Investment	7
Appeals	2

IRC § 7811(b) further provides that a TAO may require the action(s) to be taken within a specified timeframe. All of the TAOs had specified timeframes, of which ten were completed on or before the date specified. Two were completed within four days of the specified timeframe, one within 14 days, and one within 19 days. Two remain open pending resolution of all issues related to the TAO. Table 4.15 summarizes the actions requested.

TABLE 4.15, TAO REQUESTED ACTIONS

Compliance Issues	
Levy Issues	Partial release of levy to allow taxpayer to meet payroll
	Partial release of levy on partnership income
	Release of levy pending processing of corrected returns. to adjust tax liability assessed as a result of Substitute for Return assessments
Lien Issues	Review decision to not withdraw a Notice of Federal Tax lien under IRC § 6323(j)(I)(D)(3)
Appeals Issues	Provide taxpayer with Appeals hearing
Offer in Compromise Issues	Accept taxpayer's Offer in Compromise or provide explanation for rejection
	Reopen taxpayer's request for Offer in Compromise
	Reconsider rejection of Offer in Compromise based on classification of an Individual Retirement Account as a dissipated asset

Processing Issues

Refund Issues	Issue manual refund of Earned Income Tax Credit to relieve a taxpayer's hardship
	Issue a Direct Deposit manual refund
	Waive requirement to provide verification of bank account information and issue Direct Deposit manual refund to FEMA worker in hurricane disaster area
Earned Income Tax Credit Issues	Acknowledge and assign TAS Operations Assistance. Request to make a determination regarding a taxpayer's entitlement to the Earned Income Tax Credit
Penalty Issues	Abate Trust Fund Recovery Penalty
Account Adjustment Issues	Reconsider abatement of Substitute for Return assessments

Congressional Casework

TAS is responsible for independently reviewing all tax account related inquiries sent to the IRS by members of Congress. During FY 2005, TAS received 11,509 inquiries, of which 440 were duplicates.[12] Table 4.16 highlights the top ten issues identified in Congressional inquiries.

TABLE 4.16, TOP TEN ISSUES IDENTIFIED IN CONGRESSIONAL INQUIRIES

Issue	Number
Levies (including the Federal Payment Levy Program)	634
Application for Exempt Status (Form1023/1024)	483
Copies of Returns/Transcripts/Reports/FOIA	419
Account/Notice Inquiry	416
Failure to File Penalty (FTF)/ Failure to Pay Penalty (FTP)	406
Offer in Compromise - Doubt as to Collectibility	405
Open Audit (Non RPS, EITC)	404
Reconsideration/SFR/6020B/Audit	404
Other Refund Inquiries/Issues	308
Open Unreported Income Program	294

TAS DISASTER RELIEF EFFORTS

TAS played an active role in disaster relief this past year. Even though Hurricanes Katrina, Rita, and Wilma temporarily closed offices and forced some of our employees to relocate, TAS continually sought to help victims at both the national and local levels. For example, immediately after Hurricane Katrina evacuees moved to the Houston convention center, the Houston TAS office helped those who had no documents to establish their identities. TAS employees provided transcripts to establish names and

[12] Duplicate Congressional inquiries are cases with inquiries from more than one Congressional office on the same taxpayer and the same issue. Currently, these cases are not reflected in TAS overall receipts and closure statistics.

addresses, which assisted the victims in obtaining relief benefits. TAS also participated in a four-part strategy to address disaster relief.

TAS Disaster Policy Group

The IRS's Disaster Policy Group includes representatives from TAS and each operating division and function. The group reviews the scope of each event and makes recommendations for relief, including up-to-date policy and procedural guidance to help IRS employees respond to disaster or emergency situations. Two sub-teams of the council address technical, tax related issues and personnel issues, and TAS participates on both. TAS also established its own internal Disaster Policy Group, which is comprised of the Deputy National Taxpayer Advocate and senior leaders from TAS program areas impacted by disaster efforts. The group sets policy, addresses TAS issues relating to disaster relief, and elevates service-wide or legislative issues to the IRS Disaster Relief Council. The areas addressed include finance, systems issues, communications, education, program guidance, employee issues, legal issues, and case advocacy.

Question and Answer Mechanism

TAS established a special e-mail address that TAS employees use to elevate issues or questions relating to disasters. TAS subject matter experts review, research, and answer the questions, with the analysis and answers posted to TAS' internal website and distributed through all-employee email publications. Members of the TAS Disaster Policy Group approve the responses provided through this forum for consistency and policy purposes. The group also sends a personalized response to every employee who submits a question to the e-mail address.

TAS Special Editions

TAS publishes an electronic newsletter, *Special Edition*, to convey urgent information to all TAS employees when necessary. TAS issued *Special Editions* almost daily immediately after Hurricanes Katrina and Rita to provide employees with the latest information needed to assist hurricane victims, including important intranet links, and answers to questions posed through the special e-mail address mentioned above. The *Special Edition* newsletters are also available on the TAS internal web site for employees to use as a reference tool in dealing with disasters.

Disaster Guidance

TAS developed a reference guide to use in conducting outreach to taxpayers and practitioners. The guide addressed the following activities:

FEMA Volunteers – Joint Field Office

FEMA requested 2,000 volunteers for deployment to the Gulf States area to assist with recovery efforts related to Hurricane Katrina. The IRS put in place an application process by which employees volunteered to work directly with FEMA, with concurrence from their managers and IRS business units. TAS employees' applications were reviewed for business concurrence at the Deputy National Taxpayer Advocate level. FEMA ultimately selected eight TAS employees for this effort.

Local Disaster Cadres

As part of a Strategic Relationship Management Local Council (SRMLC) initiative, or other local initiatives, TAS nominated an individual(s) to serve on teams ready to respond to local disaster issues. Participation of TAS employees on these teams varies across the country. These teams take part in a number of activities, but predominately staff FEMA Disaster Recovery Centers (DRCs) and are activated early in the disaster response process.

FEMA Disaster Recovery Centers

A Disaster Recovery Center (DRC) is a readily accessible facility or mobile office where applicants can go for information about FEMA or other disaster assistance programs. A number of agencies provide assistance at these centers. The IRS is typically present handing out disaster kits, providing transcript information, educating taxpayers on tax law provisions and changes relating to the disaster, answering taxpayer questions, referring hardship situations to TAS, and assisting taxpayers in filing claims related to disaster losses. TAS' primary function in this endeavor is an off-site support role in which the organization provides transcripts for taxpayers to use in preparing disaster claims.

FEMA Call Sites

Thousands of IRS employees in Buffalo, Dallas, Philadelphia, and Atlanta met the challenge when FEMA requested their assistance in answering FEMA's toll-free lines. TAS was prepared to provide assistance after hours, if needed. However, this need for additional support did not materialize.

Small Business Development Center (SBDC) Support

The IRS has signed a Memorandum of Understanding with the SBDC to assist in setting up joint outreach sites to help businesses affected by the disaster reestablish themselves. TAS supports this initiative by providing expedited tax return transcripts, which are useful in reconstructing financial records and completing loan applications.

Low Income Taxpayer Clinic (LITC)/American Bar Association (ABA) Support

TAS will pair ABA volunteers with LITCs to offer disaster relief assistance, which will include:

- The ABA selecting LITCs to receive disaster-related calls coming into the ABA's disaster toll-free number, with implementation planned for the 2005 filing season;
- Training and encouraging ABA volunteers to work with LITCs to pair the volunteer with the most convenient LITC site offering disaster relief assistance;
-

- TAS training LITCs and ABA volunteers on disaster casualty losses, transcripts, and related disaster issues through a phone forum; and
- TAS providing expedited transcript support to taxpayers seeking disaster relief assistance through the LITC/ABA partnership.

Red Cross /Other Site Assistance

The Red Cross refers some disaster victims to other agencies, including the IRS, for additional services, including transcript information or the filing of claims. TAS does not anticipate a large need for outreach in conjunction with the Red Cross, however, local events and special Red Cross assistance sites at the local level may dictate otherwise.

SYSTEMIC ADVOCACY

Effective systemic advocacy improves tax administration and taxpayer compliance, benefiting the IRS as well as taxpayers. The TAS Office of Systemic Advocacy works directly with the IRS on problems caused by administrative practices and helps to develop legislative recommendations, when warranted.

In the past year, TAS received notice of more than 600 potential systemic problems from TAS and IRS employees and external stakeholders, including taxpayers, practitioners, and research and academic institutions. To heighten awareness of these pressing issues and facilitate rapid responses, the National Taxpayer Advocate recently revised the Systemic Advocacy structure to include a Director of Advocacy Projects and a Director of Immediate Interventions.

OFFICE OF ADVOCACY PROJECTS

The Office of Advocacy Projects addresses systemic issues having impact and complexity that demand strategic, long-term analysis. These issues, which affect specific segments of the taxpayer population, may pertain to businesses, individuals, or non-profit entities. Systemic Advocacy and field analysts, attorney advisors, and Local Taxpayer Advocates (LTAs) wrote throughout the year on these advocacy projects, which may be designated Most Serious Problems in the Annual Report to Congress if they are not resolved timely. The Office of Advocacy Projects also supports the LTAs with their Advocacy Portfolios.[13]

ADVOCACY PORTFOLIOS

Each Local Taxpayer Advocate (LTA) maintains an Advocacy Portfolio to bring the field perspective to advocacy issues and thereby integrate case and systemic advocacy. Portfolio assignments are issues of national importance. The LTAs leverage their expertise and field contacts to promote awareness and rapid correction of systemic problems in IRS offices and campuses. LTAs identify local systemic issues; bring an experienced perspective to pending IRS program modifications, and network with peers throughout

[13] *See* Appendix II for a complete listing of these Portfolio assignments.

TAS and the operating divisions. As Portfolio Advisors, they maintain a current understanding of their topics, initiate proposals, assist in resolving problems, and monitor the progress of their Portfolios.

IMMEDIATE INTERVENTIONS

The National Taxpayer Advocate gives high priority to issues that meet "Immediate Intervention" criteria. An issue rises to the status of an Immediate Intervention when IRS actions, published or unpublished guidance, inequitable treatment, or other unusual circumstances result in an action against a taxpayer or group of taxpayers that requires immediate relief. TAS pursued the following Immediate Interventions in 2005:

- ***Electronic Filing in Puerto Rico.*** The IRS planned to discontinue Form 1040 electronic filing in Puerto Rico due to concerns about inappropriate Additional Child Tax Credit (ACTC) claims. The proposal could have caused inequitable treatment of approximately 79,000 low-income taxpayers and their practitioners. The IRS did not timely inform them of the change and they could not make the necessary adjustments for the filing season. After TAS raised this issue, the IRS decided to continue accepting electronic Forms 1040 from Puerto Rico, and have the IRS Philadelphia Campus screen these returns for ACTC eligibility.
- ***Direct Debit Installment Agreement (DDIA) Payments in Disaster Areas.*** Many issues relating to the hurricanes of 2005 rose to the level of an Immediate Intervention. Of particular importance were those hurricane victims who had existing Direct Debit Installment Agreements (DDIAs) with the IRS and whose automatic payments toward their tax liabilities were still being processed, even though many had no job or wages. The Tax Policy Board for disaster relief accepted a TAS recommendation to allow relief to taxpayers, return the payments, and suspend the DDIAs.
- ***Centralized Lien Processing.*** Several taxpayers and IRS employees raised hardship situations resulting from delays in providing payoff balances and lien releases by the Centralized Case Processing (CCP) Lien Unit. TAS, working with CCP management and staff, identified and implemented solutions.
- ***Estimated Average Preparation Times and Out-of-Pocket Expenses included in the Instructions to Form 1040.*** The year 2005 concluded with a barrage of inquiries from tax practitioners and software providers regarding instructions for individual tax returns, which the IRS issued in November. These instructions included a chart outlining the estimated average preparation times and out-of-pocket expenses for each return preparation method. The chart stratifies this information by hours and costs in three categories:
  - Self-Prepared Without Tax Software;
  - Self-Prepared With Tax Software; and
  - Prepared by Paid Professional.

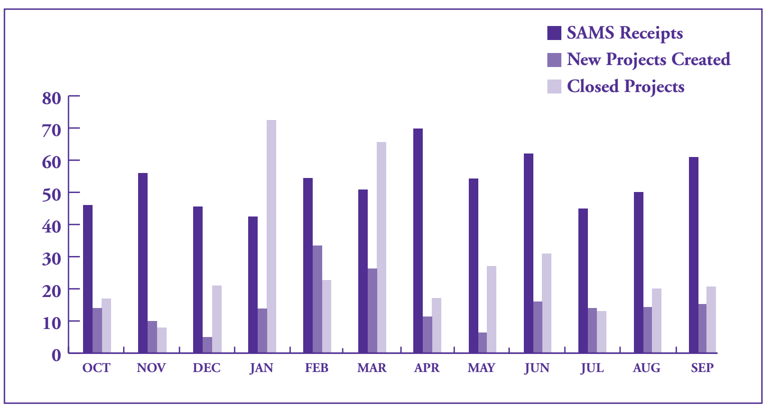
The information caused a great deal of concern for practitioners, who felt it gave the impression of dictating a reasonable price for their services. The software community also expressed concerns because the chart indicated it is more cost effective and time efficient to prepare a paper return rather than file a return electronically.

SYSTEMIC ADVOCACY RECEIPTS AND PROJECTS

The TAS Office of Systemic Advocacy reviews and assigns advocacy work through the Systemic Advocacy Management System (SAMS). The Office of Systemic Advocacy tracks its work on SAMS, a web-based application available to IRS employees and the public.[14] Systemic Advocacy employees review all issue submissions and apply criteria that categorize and develop the issues into projects when appropriate, or assimilate new issues into existing projects.

Table 4.17 illustrates monthly issue receipts, new advocacy projects created from receipts and project closures for fiscal year 2005.

TABLE 4-17, FY 2005 SAMS RECEIPTS, NEW PROJECTS, AND CLOSURES



During fiscal year 2005, the Office of Systemic Advocacy received 635 advocacy issues, with the majority coming via SAMS.[15] The public (taxpayers, academics, and tax professionals) submitted approximately 17 percent of SAMS issues via the Internet. TAS and other IRS employees delivered the remaining issues directly into SAMS using the IRS intranet.

The number of submissions declined by 34 percent from FY2004, a trend attributed to IRS and TAS employees growing more familiar with SAMS and the criteria for a systemic issue. Thus, Systemic Advocacy received a larger number of appropriate submissions

14 SAMS is a database of advocacy issues submitted to TAS by employees and the public and the projects created from these issues. The Internet version of SAMS is available through the Systemic Advocacy pages of the TAS website at http://www.irs.gov/advocate.

15 A limited number of advocacy issues come into the Office of Systemic Advocacy through outreach and emails directly to the National Taxpayer Advocate and the Executive Director of Systemic Advocacy. These are input and tracked on SAMS along with issues sent directly through the system.

and accepted fewer that required transfer to other IRS units. These transfers fell almost 200 percent from FY 2004, with the largest decrease involving questions and suggestions for improving TAS case processing procedures and policy. TAS brought a new database online to track and respond to these types of questions in April 2005.[16]

Systemic Advocacy reviews all issue submissions using established criteria to prioritize inventory and develop advocacy projects.[17] If an issue meets criteria and all facts are present, Systemic Advocacy ranks the issue to assess its general scope, visibility and sensitivity, and the interest it generates among members of Congress, the media, and stakeholders. The ranking process also considers the impact on taxpayer burden and taxpayer rights as well as TAS's ability to effect change by working the issue. Systemic Advocacy developed approximately 28 percent of submissions into new projects during FY 2005, creating 175 projects in all. Meanwhile, the number of closed (completed) projects rose almost 20 percent over FY 2004.

As the above statistics depict, most submissions do not become projects. Some (*e.g.*, local issues, tax law questions) may not truly represent systemic problems, while others, such as requests for IRS system changes, can be better handled through existing IRS processes. However, Systemic Advocacy staff continually assesses all submissions to identify trends and gain a comprehensive understanding of problems.

CHART 4-18, TOP SYSTEMIC ADVOCACY PROJECT CATEGORIES

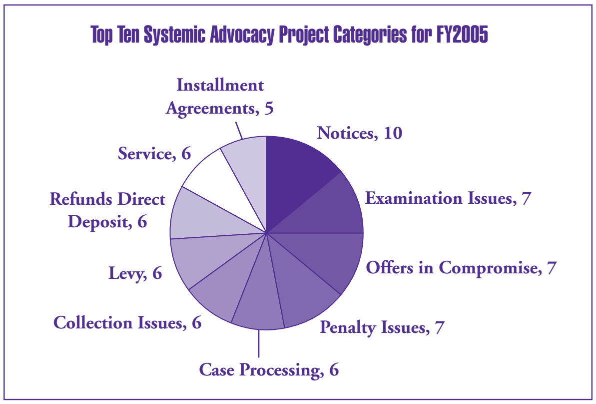


Table 4.19 outlines the top 25 systemic issue topics in SAMS by major issue (MI) codes that correspond to tracking on TAMIS, the TAS database of individual taxpayer cases. Some of the advocacy issues do not directly match with TAMIS MI Codes because cases usually relate to service and account problems. For example, Earned Income Tax Credit

[16] The CAPER (Cases and Correspondence - Analysis - Policy and Procedure – Evaluative - Review) system, a forum for TAS field and campus offices to submit questions, issues, and suggestions to the TAS Taxpayer Accounts Operations (TAO) office, became operational in FY 2005.

[17] Submissions identifying issues that are so highly visible, sensitive, or urgent that there is no time for normal corrective steps to occur are elevated as Immediate Intervention projects and assigned immediately.

ADVOCACY

is listed under Exam MI Codes and does not have a separate code for problems with the related EITC law. Systemic advocacy issues often address problems with either a lack of or inadequate guidance, or difficulty applying tax law.

TABLE 4-19, TOP 25 ISSUES RECEIVED IN SAMS FOR FY 2005

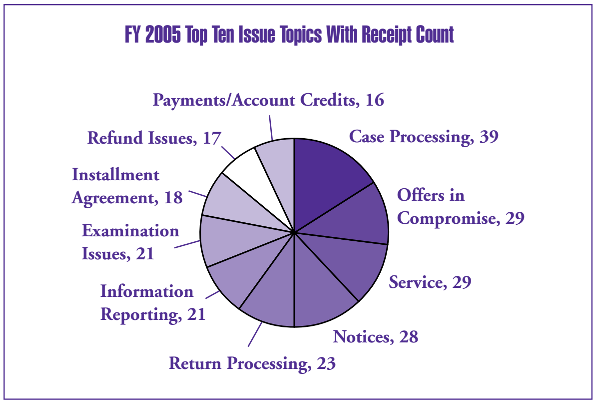
MI Code	Description	FY05 Advocacy Receipts
N/A	Case Processing	39
780	Offers in Compromise (OIC)	29
100	Service	29
111	Notices	28
301	Return Processing	23
390	Information Reporting	21
600	Examination Issues	21
751	Installment Agreements	18
000	Refund Issues	17
200	Payments/Account Credits	16
701	Collection Issues	15
410	Multiple/Mixed ID Numbers	15
100	Form or Publication Issue	14
105	Determinations	14
500	Penalty Issues	14
N/A	Income Issues	13
710	Levy	13
720	Lien	13
N/A	Extension to File	11
400	Entity Issues	11
330	Amended Return	10
990	Access to IRS	9
630-640	Earned Income Tax Credit (EITC)	9
830	Interest Calculation	9
340	Injured Spouse (Form 8379)	8

Ongoing SAMS enhancements include the addition of a project history screen for analysts to facilitate project management and another screen to allow SAMS issue reviewers to make notations during the ranking process.

Chart 4.20 illustrates the top ten SAMS issues in fiscal year 2005. The following topics from FY 2004 are no longer among the top ten receipts: Earned Income Tax Credit (EITC), Individual Taxpayer Identification Number (Form W-7), Penalty Issues, and Form/Publication Issue. These were replaced by Examination Issues, Refund Issues, Payments/Account Credits, and Case Processing.

CHART 4-20, TOP TEN ISSUE TOPICS RECEIVED IN SAMS IN FY 05

INTERNAL REVENUE MANUAL AND INTERNAL MANAGEMENT DOCUMENT (IMD) REVIEW



In addition to addressing matters of priority concern, the Office of Immediate Interventions is the Single Point of Contact (SPOC) for review of all internal management documents (such as interim guidance, policy statements, or delegations order) including the Internal Revenue Manual (IRM) that affects taxpayers. Review of these documents not only focuses on taxpayer rights and burden, but also on tracking these documents to ensure that, the IRM properly incorporates the recommendations of each Annual Report to Congress.

TAS received 346 Internal Revenue Manual and Internal Management Documents (IMDs) for review and provided feedback on 113, placing particular importance on Collection IRMs relating to liens, levies, and managerial involvement and oversight in these processes. TAS also provided a response on guidance relating to time frames for receiving and processing Collection Due Process (CDP) hearing requests to ensure taxpayers were allowed adequate time to respond before IRS took collection action.

OTHER INITIATIVES

The following table lists some of the initiatives and projects pursued by Systemic Advocacy in fiscal year 2005.

TABLE 4-21, SYSTEMIC ADVOCACY INITIATIVES 2005

Systemic Initiative	Actions Taken
Private Debt Collection Initiative	The NTA has identified seven areas for particular attention: contractor training, policies and procedures, taxpayer privacy, notices, complaint processes, case selection criteria and exclusion codes, and contractor monitoring and case research of the PDC initiative scheduled for July 2006. The IRS should establish procedures for taxpayers treated unfairly by debt collectors could get TAS assistance.[18]
Taxpayer Assistance Centers (TACs)	Assess the effects of IRS decreases in service by monitoring their impact on TAS inventory, using a special TAMIS code to track workload results.[19]
Taxpayer Rights Training	Reviewed the IRS course material developed for newly hired Compliance employees and Appeals officers and determined that it did not systematically address taxpayer rights.
Uniform Definition of a Qualifying Child (UDOQC)	Address the implementation of UDQOC and its impact on tax provisions and processes. The IRS is training employees servicewide and TAS will deliver an Interactive Video Training (IVT).
Collections Statute Expiration Dates (CSEDs)	Identify methods to correct accounts with erroneous or miscalculated CSEDs areas such as installment agreements, offer in compromise and substitute for return accounts. The IRS has corrected over one million accounts where taxpayer requests for installment agreements had caused an incorrect extension of the statute. The IRS is running extracts to identify monies that may have been incorrectly withheld from taxpayers.
Federal Payment Levy Program (FPLP)	Work is underway with the Wage and Investment Operating Division to develop an effective income exclusion model to protect taxpayers with limited incomes from being levied upon. IRS's proposal provides specific due dates on notices for payment instead of the generic 30 days.[20]
Appeals-SB/SE Fast Track Settlement Initiative Team	TAS participated in a team that developed a more efficient Alternative Dispute Resolution (ADR) strategy for SB/SE cases.
IRS SB/SE Audit Reconsideration Task Force	Analyzed the entire audit reconsideration process and reviewed the TAS EITC Audit Reconsideration study to substantially modify changes to the process, include a revised policy statement and IRM. Future training is planned for campus employees.
IRS SB/SE Innocent Spouse Task Force	Advocacy Projects joined a cross-functional team charged with redesigning Form 8857, Request for Innocent Spouse Relief. The new form is to allow for earlier determinations and eliminate additional correspondence to the taxpayer. TAS' goal is to ensure that taxpayer rights and burden issues are considered.[21]
Notice Strategy Planning	This initiative includes a five-year, servicewide notice improvement plan. The group envisions creating a list of all notices by type and function, intended purpose, mailing costs, volumes, and content to determine which notices to change, add, or eliminate.

[18] *See* Most Serious Problem: *Private Debt Collection Initiative, supra.*

[19] *See* Most Serious Problem: *Taxpayer Service, supra.*

[20] *See* Most Serious Problem: *Levies On Social Security Payments, supra.*

[21] *See* Most Serious Problem: *Innocent Spouse Claims, supra.*

TOP 25 CASE ADVOCACY ISSUES

TOP 25 CASE ADVOCACY ISSUES FOR FY 2005 IDENTIFIED BY TAMIS RECEIPTS

Core Issue Code	Description	Total
95x	Criminal Investigation	26,505
63x-640	EITC Certification/Recertification/ Reconsideration/ Revenue Protection Strategy	14,180
330	Processing Amended Returns	11,919
71x	Levies	10,131
310	Processing Original Returns	8,866
620	Reconsideration/Substitute For Return/6020b/Audit	7,425
020	Expedite Refund Requests	6,931
340	Injured Spouse Claim	6,283
670	Closed Underreporter	5,816
150	Copies of Returns/Transcripts/Reports/FOIA	5,449
610	Open Audit (non-RPS,EITC)	5,215
72x	Liens	5,045
210	Missing/Incorrect Payments	3,807
520	Failure To File / Failure To Pay Penalties	3,603
090	Other Refund Issues	3,225
390	Other Document Processing Issues	2,966
450	Form W-7/ITIN/ATIN	2,744
660	Open Automated Underreporter	2,731
060	IRS Offset	2,628
675	CAWR/FUTA	2,572
75x	Installment Agreements	2,572
010	Lost or Stolen Refunds	2,514
110	Account/Notice Inquiries	2,367
78x	Offers In Compromise	2,279
040	Returned/Stopped Refunds	2,221
	Total	**149,994**
	Grand Total - All TAS Cases FY 2005	**190,153**

ADVOCACY PORTFOLIOS

ADVOCACY PORTFOLIOS

Portfolio	LTA Name	State/Office	Phone Number
Abusive Schemes	Zelle, J	MO	314-612-4610
Appeals: ADR	McMurray, T	IL Springfield	217-862-6382
Appeals: CDP Hearings	Gorga, P	NY Manhattan	212-436-1011
Appeals: Nondocketed Inventory	Logan, A	WY	307-633-0800
Appeals: Nondocketed Inventory (Campus)	Safrey, E	BSC	631-654-6686
Appeals: Nondocketed Inventory (Field)	Trudeau, M	ID	208-387-2927
Audit Reconsiderations	Keleman, L	CA Los Angeles	213-576-3140
Audit Reconsiderations (Audit Recon/ASFR/6020B	Carey, W	ATSC	770-936-4500
AUR Exam	Boucher, D	ME	207-622-8528
Backup Withholding	Adams, M	KS	316-352-7506
Bankruptcy Processing Issues	Mettlen, A	PA Pittsburgh	412-395-5987
Campus Consistency	Wess, D	MSC	901-395-1900
Carryback/Carryforward Claims	Blair, C	OSC	801-620-7168
CAWR/FUTA	Keating-Jones, J	OR	503-326-7816
Centralized Lien Filing and Releases	Diehl, M	CSC	859-669-5316
Criminal Investigation Cases (CI) & Criminal Investigation Freezes	Sawyer, M	FSC	559-442-6400
Collection Contract Support	Kleckley, F	SC	803-253-3029
CSEDs	Sherwood, T	CO	303-446-1012
EITC: Certification/Precertification	Mings, L	KCC	816-926-2493
EITC: Exam Re-engineering (Math Error)	Martinez, L	NM	505-837-5505
EITC: Notice Redesign	Taylor, S	IL Chicago	312-566-3800
EITC: Outreach and Education, Financial Literacy	Mapp, T	PA Philadelphia	215-861-1304
EITC: Outreach and Education, Rural	Allen, B	GA	404-338-8099
EITC: Recertification	Lewis, C	LA	504-558-3001
EO Applications, Penalties, Education, and Outreach	Finnesand, M	SD	605-226-7248
ETA/Electronic Filing	Martin, B	TN	615-250-5000
ETA/Electronic Return Originators	Scott, C	OK	405-297-4055
Examination Strategy	Revel-Addis, B	FL Jacksonville	904-665-1000
Excise Tax	Diehl, M	CSC	859-669-5316
Federal Payment Levy Program (FPLP)	Morris, R	WI	414-297-3046
FPLP Communication	O'Shaughnessy, M	NH	603-433-0571
Filing Season Readiness/SPEC	Douts, K	AK	907-271-6877
Frontline Leader Readiness Program (FLRP)	Kitson, A	NY Brooklyn	718-488-2080
Health Care Tax Credit (HCTC)	Cummings, L	TX Dallas	214-413-6500
Identity Theft	Safrey, E	BSC	631-654-6686
Injured Spouse	Post, T	WV	304-420-6616
Innocent Spouse Relief: IRC § 6015	Adams, C	CA Laguna Nigel	949-389-4804
Installment Agreements: Allowable Expenses (High Cost)	Moore, L	FL Ft. Lauderdale	954-423-7677
Installment Agreements: Allowable Expenses (Low Cost)	Washington, J	MS	601-292-4800
Installment Agreements: Processing	Tam, T	CA Oakland	510-637-2703
Interest Computations, Abatement of Interest	Romano, F	CT	860-756-4555

ADVOCACY PORTFOLIOS (CONT.)

Portfolio	LTA Name	State/Office	Phone Number
International Taxpayers	Puig, JC	PR	787-622-8930 (S) 787-622-8940 (E)
IRS Training on Taxpayers Rights	Hickey, M	NE	402-221-4181
ITIN Outreach	Blount, P	MI	313-628-3670
ITIN Processing	Dowd, L	PSC	215-516-2499
Levy (710) [Hardship determination linked to release of levy]	Polson, R	IA	515-284-4780
Lien Release, Lien Withdrawal, Lien Subordination, Lien Discharge	Lauterbach, L	NJ	973-921-4043
LITC	Lewis, C	LA	504-558-3001
Manual Refunds	Strayer, C	OH Cleveland	216-522-7134
Mentoring	Coss, V	ANC	978-474-5549
Mixed and Scrambled TINs (Multiple/Mixed TINS (410))	Murphy, M	AZ	602-207-8240
Multilingual Initiative	Glass, D	TX Austin	512-499-5875
Navigating the IRS	Gray, P	AR	501-324-6269
Nonfiler Strategy	Bjornson, B	MN	651-312-7999
Notice Clarity	Smith, G	NY Albany	518-427-5413
Notice Clarity (Account/Notice Inquiry Transfer Criteria (110)	Egan, C	RI	401-525-4200
OIC (Field, COIC)	Burns, L	KY	502-582-6030
OIC (Field, ETA, COIC)	Sonnack, B	TX Houston	713-209-3660
Outreach to ESL Taxpayers (including ITINs)	Puig, JC	PR	787-622-8930 (S) 787-622-8940 (E)
Outreach and Marketing to Low Income TPs (Marketing too)	Grant, D	NV	702-455-1241
Penalties: e.g. failure to pay, abatements, adjustments, estimated	Sherwood, T	CO	303-446-1012
Position Management	Wirth, B	NY Buffalo	716-686-4850
Practitioner Priority Services	Beck, J	WA	206-220-6037
Preparer Penalties	Votta, P	MD	410-962-2082
Returned/Stopped Refunds	Gilchrist, M	AL	205-912-5631
Schedule K-1 Matching	Sheely, K	IN	317-226-6332
Seizure and Sale	Beck, J	WA	206-220-6037
TACs-Rural	Foard, L	ND	701-239-5141
TACs-Urban and Communications	VanHorn, C	OH Cincinnati	513-263-3260
TAS Confidentiality/IRC 6103	Bjornson, B	MN	651-312-7999
Tax Exempt Entities: EP Penalties	Blair, C	OSC	801-620-7168
Tax Exempt Entities: EP returns (Forms 5500)	Blair, C	OSC	801-620-7168
Tax Exempt Entities: Tribal Government Issues	Wirth, B	NY Buffalo	716-686-4850
Tax Forums	Allen, B	GA	404-338-8099
TIGTA/GAO	Thompson, T	MT	406-441-1022
Tip Reporting	Grant, D	NV	702-455-1241
Transcript Delivery System (Copies of returns, transcripts, reports, FOI	Cooper-Aquilar, S	UT	801-799-6958
Transition of SB Work	Keleman, L	CA Los Angeles	213-576-3140
Trust Fund Recovery Penalty	Campbell, M	VA	804-916-3501

MOST LITIGATED TAX ISSUES: TABLES OF LITIGATED CASES

TABLE 1

APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330

Case Cite	Issue(s)	*Pro Se*	Decision
Individual Taxpayers (Issues Other Than Business)			
Adams v. Comm'r, 95 A.F.T.R.2d (RIA) 1862 (9th Cir. 2005)	Frivolous issues	Yes	IRS
Alaniz v. Comm'r, T.C. Memo. 2005-4	Rejection of OIC as abuse	No	IRS
Ali v. U.S., 95 A.F.T.R.2d (RIA) 1319 (S.D. Ohio 2005)	Tax Court jurisdiction on slavery reparations refund issue	Yes	IRS
Anderson v. Comm'r, T.C. Dckt. No. 8869-04S (March 21, 2005)	Financial hardship	Yes	IRS
Antlocer v. U.S., 94 A.F.T.R.2d (RIA) 5141 (9th Cir. 2004)	Equivalent hearing, no jurisdiction	Yes	IRS
Asemani v. Comm'r, 94 A.F.T.R.2d (RIA) 6628 (M.D. Pa. 2004)	Jurisdiction where no CDP notice issued	Yes	IRS
Austin v. Comm'r, 95 A.F.T.R.2d (RIA)2304 (E.D. Cal. 2005)	Late filing of petition, no jurisdiction	Yes	IRS
Avula v. Comm'r, 94 A.F.T.R.2d (RIA) 5267 (8th Cir. 2004)	Inability to argue liability	Yes	IRS
Balice v. Comm'r, T.C. Memo. 2005-35	Late filing of petition, no jurisdiction	No	IRS
Banis v. Comm'r, T.C. Memo. 2004-237	Liability not discharged	Yes	IRS
Barnett v. U.S., 366 F.3d 1243 (11th Cir. 2004)	Validity of assessment	Yes	IRS
Bartley v. U.S., 343 F.Supp.2d 649 (N.D. Ohio 2004)	Frivolous issues	Yes	IRS
Berger v. Comm'r, T.C. Dckt. No. 19535 (March 21, 2005)	Ability to argue liability	Yes	TP
Beverly v. Comm'r, T.C. Memo. 2005-41	Automatic stay in bankruptcy	Yes	TP
Black v. Comm'r, T.C. Memo. 2005-46	Rejection of OIC as abuse	Yes	IRS
Blankenship v. U.S., 94 A.F.T.R.2d (RIA) 5947 (S.D. Tex. 2004)	Verification requirements satisfied	Yes	IRS
Boyd v. U.S., 95 A.F.T.R.2d (RIA) 847 (10th Cir. 2005)	Frivolous issues	Yes	IRS
Borchardt v. Comm'r, 338 F.Supp.2d 1040 (D. Minn. 2004)	Right to make recording of hearing	Yes	IRS
Broderick v. Comm'r, 95 A.F.T.R.2d (RIA) 1004 (9th Cir. 2004)	Propriety of motion for summary judgment and sanctions	Yes	IRS
Brookbank v. Comm'r, T.C. Dckt. No. 19226-02L (Feb. 28, 2005)	Frivolous issues	Yes	IRS
Brown v. Comm'r, T.C. Summ. Op. 2004-130.	Reliance on IRS to abate of interest	Yes	IRS
Brown v. Comm'r, T.C. Summ. Op. 2005-37	Inability to argue liability	Yes	IRS
Brozgal v. Comm'r, T.C. Dckt. No.8159-04S (March 21, 2005)	TP could not prove liability issue	Yes	IRS
Burke v. Comm'r, 124 T.C. 189 (2005)	Frivolous issues	Yes	IRS
Burns v. U.S., 95 A.F.T.R.2d (RIA) 1160 (M.D. Tenn. 2005)	Filed appeal in wrong court	Yes	IRS
Burns v. U.S., 95 A.F.T.R.2d (RIA) 1599 (M.D. Tenn. 2005)	Right to face-to-face hearing	Yes	IRS
Calderone v. Comm'r, T.C. Memo. 2004-240	Ability to argue liability	No	TP
Canaday v. U.S., 94 A.F.T.R.2d (RIA) 6311 (S.D. W.Va. 2004)	Filed appeal in wrong court	Yes	IRS
Cansino v. Comm'r, 94 A.F.T.R.2d (RIA) 7256 (9th Cir. 2004)	Jurisdiction for Tax Court	Yes	IRS
Cardona v. Comm'r, 94 A.F.T.R.2d (RIA) 7148 (2nd Cir. 2004)	Frivolous issues	Yes	IRS
Casey v. Comm'r, T.C. Memo. 2004-228	Failure to offer face-to-face as abuse	Yes	IRS
Castillo v. Comm'r, T.C. Memo. 2004-238	Rejection of IA not abuse	No	IRS
Cena v. Comm'r, 94 A.F.T.R.2d (RIA) 2927 (W.D. Tex. 2005)	Failure to state a claim	Yes	IRS
Chandler v. Comm'r, T.C. Memo. 2005-99	Refusal to grant face-to-face and rejection of OIC	Yes	IRS
Chocallo v. Comm'r, T.C. Memo. 2004-152	Jurisdiction to grant relief requested	Yes	IRS
Christofferson v. Comm'r, T.C. Dckt. No. 5730-04S (March 3, 2005)	Inability to argue liability	Yes	IRS
Cianflone v. IRS, 95 A.F.T.R.2d (RIA) 1601 (D. Md. 2005)	Failure to state a claim	Yes	IRS
Collier v. Comm'r, T.C. Memo. 2004-171	Not processing OIC as abuse	Yes	IRS
Cobin v. Comm'r, 95 A.F.T.R.2d (RIA) 717 (D. S.C. 2005)	Filed Appeal in wrong court	Yes	IRS
Conner v. Comm'r, T.C. Summ. Op. 2005-27	No IRS delay to abate interest	Yes	IRS
Crass v. Comm'r, T.C. Dckt. No. 9616-04S (2005)	Inability to argue liability	Yes	IRS
Currie v. U.S., 95 A.F.T.R.2d (RIA) 1961 (N.D. Ga. 2005)	Inability to argue liability	Yes	IRS
Dalton v. Comm'r, T.C. Memo. 2005-7	Inability to argue liability	Yes	IRS
Dashiell v. Comm'r, T.C. Memo. 2004-210	Frivolous issues	Yes	IRS

TABLE 1: APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330 (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
Deaton v. Comm'r, T.C. Memo. 2005-1	Underlying liability, claim of credit	No	IRS
Del Vecchio v. Comm'r, T.C. Memo. 2004-218	Validity of assessment	Yes	IRS
Demus v. Comm'r, T.C. Dckt. No. 6636-04L (Jan. 31, 2005)	Adequacy of Notice of Determination	Yes	TP
Desalvo v. Comm'r, T.C. Summ. Op. 2004-166	Inability to argue liability and rejection of OIC as abuse	Yes	IRS
Devries v. Comm'r, 359 F.Supp.2d 988 (E.D. Cal. 2005)	Anti-Injunction Act as bar to relief	Yes	IRS
Dick v. Comm'r, T.C. Dckt. No. 13102-04L (April 27, 2005)	Inability to argue liability	Yes	IRS
Doing v. Comm'r, 95 A.F.T.R.2d (RIA) 1867 (9th Cir. 2005)	Inability to argue liability	Yes	IRS
Dysle v. Comm'r, T.C. Memo. 2004-285	IRS application of payments	Yes	IRS
Eberhardt v. Comm'r, T.C. Summ. Op. 2004-147	Inability to argue liability, rejection of OIC, abatement of interest	Yes	IRS
Eckert v. Comm'r, T.C. Memo. 235	Misapplication of payments	Yes	IRS
Edwards v. U.S., T.C. Summ. Op. 2004-158	Leaving NFTL in place as abuse	Yes	IRS
Elkins v. U.S., 95 A.F.T.R.2d (RIA) 597 (M.D. Ga. 2004)	TP provides no alternatives	Yes	IRS
Farley v. Comm'r, T.C. Memo. 2004-168	Inability to argue liability	Yes	IRS
Fishbach v. Comm'r, T.C. Memo. 2005-38	Inability to argue liability	Yes	IRS
Florance v. Comm'r, T.C. Memo. 2005-61	Frivolous issues	Yes	IRS
Forman v. U.S., 95 A.F.T.R.2d (RIA) 1633 (N.D. Ill. 2005)	Lack of standing for husband and wife	No	IRS
Fowler v. Comm'r, T.C. Memo. 2004-163	Use of national expense standards	Yes	TP
Frate v. Comm'r, T.C. Summ. Op. 2004-91	Whether levied wages embezzled	Yes	IRS
Gardner v. Comm'r, 95 A.F.T.R.2d (RIA) 2032 (D. N.J. 2005)	Face-to-face hearing and validity of hearing	Yes	IRS
Gatlos v. Comm'r, T.C. Memo. 2004-192	Frivolous issues	Yes	IRS
Gavigan v. Comm'r, T.C. Summ. Op. 2004-155	Frivolous issues	Yes	IRS
Geary v. Comm'r, T.C. Summ. Op. 2005-16	Inability to argue liability	Yes	IRS
Gerakios v. Comm'r, T.C. Memo. 2004-203	Moot issues, liability paid	Yes	IRS
Gibson v. Comm'r, T.C. Dckt. No. 19577-04S (May 12, 2005)	Inability to argue liability	Yes	IRS
Gilligan v. Comm'r, T.C. Memo. 2004-194	Frivolous issues	Yes	IRS
Goblirsch v. Comm'r, T.C. Memo. Op. 2005-78	Liability for capital gains tax	Yes	IRS
Griffith v. Comm'r, T.C. Memo. 2004-267	Expiration of collection statute	Yes	IRS
Hamzik v. Comm'r, T.C. Memo. 2004-223	Frivolous issues	Yes	IRS
Harris v. Comm'r, T.C. Summ. Op. 2005-25	No evidence presented as to liability, rejecting OIC as abuse of discretion	Yes	IRS
Hayes v. Comm'r, T.C. Memo. 2005-57	Whether TP had paid liability	Yes	TP
Henderson v. Comm'r, T.C. Memo. 2004-157	Frivolous issues	Yes	IRS
Hendricks v. Comm'r, T.C. Memo. 2005-72	Innocent spouse	No	TP
Herip v. U.S., 95 A.F.T.R.2d (RIA) 537 (6th Cir. 2004)	Whether all procedures were followed	No	IRS
Hibben v. U.S., 95 A.F.T.R.2d (RIA) 2063 (E.D. Ky. 2005)	Raising CDP in summons case	Yes	IRS
Hiland v. Comm'r, T.C. Memo. 2004-225	Frivolous issues	Yes	IRS
Holguin v. Comm'r, 94 A.F.T.R.2d (RIA) 5803 (9th Cir. 2004)	Frivolous issues	Yes	IRS
Hobbs v. Comm'r, 95 A.F.T.R.2d (RIA) 6194 (9th Cir. 2004)	Frivolous issues	Yes	IRS
Holliday v. Comm'r, T.C. Memo. 2004-172	Whether all procedures were followed	Yes	IRS
Holmes v. Comm'r, 351 F.Supp.2d 526 (W.D. La. 2004)	Failure to appear at CDP hearing	Yes	IRS
Howard v. Comm'r, T.C. Memo. 2005-100	Frivolous issues	Yes	IRS
Hudspath v. Comm'r, T.C. Memo. 2005-83	Inability to raise liability	Yes	IRS
Israel v. U.S., 93 A.F.T.R.2d (RIA) 2044 (S.D. Iowa 2005)	Filed appeal in wrong court	Yes	IRS
Jackling v. Comm'r, 352 F.Supp.129 (D. N.H. 2004)	Inability to argue liability	Yes	IRS
Jackson v. Comm'r, T.C. Summ. Op. 2005-12	Abatement of interest and penalties	Yes	Split
Johnson v. Comm'r, T.C. Summ. Op. 2005-47	Ignoring TP's poverty as abuse	Yes	TP
Johnston v. Comm'r, T.C. Memo. 2004-224	Frivolous issues	Yes	IRS
Johnston v. U.S., 95 A.F.T.R.2d (RIA) 699 (9th Cir. 2005)	Filed appeal in wrong court	Yes	IRS

TABLE 1: APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330 (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
Judd v. Comm'r, T.C. Summ. Op.. 2005-59	Application of payments	Yes	IRS
Kaplowitz v. Comm'r, T.C. Memo. 2005-62	Frivolous issues	Yes	IRS
Kara v. Comm'r, T.C. Dckt. No. 7748-02L (Jan. 25 2005)	Sufficiency of CDP notice	Yes	TP
Karns v. Dix, 95 A.F.T.R.2d (RIA) 1593 (D. S.D. 2005)	Jurisdiction to sue IRS employees	Yes	IRS
Kelby v. Comm'r, T.C. Memo. 2005-25	Whether all procedures followed	No	IRS
Kendricks v. Comm'r, 124 T.C. 69 (2005)	Rejection of OICs as abuse	No	IRS
Khalid v. U.S., 95 A.F.T.R.2d (RIA) 1860 (E.D. Pa. 2005)	Prerequisite of CDP hearing request	Yes	IRS
Kilgore v. Comm'r, T.C. Memo. 2005-24	Frivolous issues	Yes	IRS
Kim v. Comm'r, T.C. Memo. 2005-96	Erroneous notice of determination	Yes	IRS
Klet v. Comm'r, T.C. Summ. Op. 2004-172	Discharge of liability in bankruptcy	Yes	Split
Kolker v. Comm'r, T.C. Memo. 2004-288	Frivolous issues	Yes	IRS
Kone v. U.S, 94 A.F.T.R.2d (RIA) 6924 (D. Md. 2004)	Jurisdiction when appeal filed late	Yes	IRS
Krueger v. Comm'r, T.C. Memo. 2005-105	Frivolous issues	Yes	IRS
Kubon v. Comm'r, T.C. Memo. 2005-71	Frivolous issues	Yes	IRS
Kun v. U.S., T.C. Memo. 2004-209	Ability to argue liability, rejection of OIC as abuse of discretion	Yes	IRS
Kupcho v. Comm'r, 95 A.F.T.R.2d (RIA) 1439 (D. N.J. 2005)	Filed appeal in wrong court	Yes	IRS
Kyles v. Comm'r, T.C. Dckt. No. 9213-04S (March 15, 2005)	Lack of notice as abuse of discretion	Yes	IRS
Laing v. Comm'r, 94 A.F.T.R.2d (RIA) 7225 (W.D. Tex. 2004)	Lack of notice as abuse of discretion	No	IRS
Langer v. U.S., 95 A.F.T.R.2d (RIA) 894 (8th Cir. 2005)	FICA taxes incorrectly assessed	No	TP
LeDoux v. U.S., 375 F.Supp.2d 1242 (D. NM 2005)	Whether all procedures followed	Yes	IRS
Lee v. Comm'r, T.C. Memo. 2004-264	IRS refusal to record as abuse	Yes	IRS
Lehman v. Comm'r, T.C. Memo. 2005-90	Frivolous issues	Yes	IRS
Lister v. U.S., 94 A.F.T.R.2d (RIA) 5342 (10th Cir. 2004)	Frivolous issues	Yes	IRS
Littriello v. Comm'r, 2005 WL 1173277 (W.D. Ky. 2005)	Validity of IRS regulations	No	IRS
Lozon v. Comm'r, 94 A.F.T.R.2d (RIA) 5234 (E.D. Mich. 2004)	Right to record hearing and notice as constitutional issues	Yes	IRS
Lykes v. Comm'r, T.C. Memo. 2004-159	Reasonable cause to abate penalties	Yes	IRS
Mackinnon v. Fredrickson, 95 A.F.T.R.2d (RIA) 1973 (D. Or. 2005)	Filed appeal in wrong court	Yes	IRS
Malis v. Comm'r, 95 A.F.T.R.2d (RIA) 1002 (9th Cir. 2005)	IRS refusal to record as abuse	Yes	IRS
McBride v. Comm'r, T.C. Memo. 2004-178	Frivolous issues	Yes	IRS
McCauley v. U.S., 2004 WL 2106544 (E.D. Pa. 200)	Whether all procedures followed	Yes	IRS
McCorckle v. Comm'r, 124 T.C. 56	Equitable estoppel against IRS	Yes	IRS
McCurdy v. Comm'r, 95 A.F.T.R.2d (RIA) 2776 (D. Mass. 2005)	IRS refusal to record	Yes	IRS
McElroy v. Comm'r, T.C. Memo. 2004-254	Refusal to abate interest as abuse	Yes	IRS
McNamara v. U.S., T.C. Summ. Op. 2005-22	Abuse to proceed with collection	Yes	IRS
Meadows v. Comm'r, 405 F.3d 949 (11th Cir. 2005)	Application of payment as violation of bankruptcy stay	No	IRS
Meehan v. Comm'r, 122 T.C. 396 (2004)	Severance as "wages" within meaning of CDP regulations	Yes	IRS
Meyer v. Comm'r, 95 A.F.T.R.2d (RIA) 2471 (W.D. Wis. 2005)	Frivolous issues	Yes	IRS
Meyer v. Comm'r, T.C. Summ. Op. 2005-82	Frivolous issues	Yes	IRS
Molina v. Comm'r, T.C. Memo. 2004-258	Distribution from plan as taxable	Yes	TP
Moore v. Comm'r, T.C. Memo. 2005-93	Inability to argue liability	Yes	IRS
Moran v. Comm'r, 94 A.F.T.R.2d (RIA) 5840 (N.D. Ill. 2004)	Whether payments made	No	IRS
Mosby v. U.S., 94 A.F.T.R.2d (RIA) 5598 (9th Cir. 2004)	No review in equivalent hearing	Yes	IRS
Nguyen v. Comm'r, T.C. Summ. Op. 2004-144	Inability to argue liability	Yes	IRS
Norton v. Comm'r, T.C. Memo. 2005-44	Interest and penalties as paid from seized funds	Yes	IRS
Olsen v. Comm'r, 326 F.Supp.2d 184 (D. Mass. 2004)	Rejection of OIC as abuse	No	IRS
Orum v. Comm'r, 123 T.C. 1, aff'd, 412 F.3d 819 (7th Cir. 2005)	Jurisdiction to order IA acceptance	Yes	IRS
Parker v. Comm'r, T.C. Memo. 2004-226	Hearing at closest Appeals office	Yes	TP

TABLE 1: APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330 (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
Peterson v. Kreidich, 95 A.F.T.R.2d (RIA) 2416 (11th Cir. 2005)	Filed appeal in wrong court	Yes	IRS
Picchiottino v. Comm'r, 2004-231	Collection statute of limitations	Yes	IRS
Picchiottino v. Comm'r, 2004-232	Collection statute of limitations	Yes	IRS
Pixely v. Comm'r, 123 T.C. 269 (2004)	Rejection of tithe expense as abuse	No	IRS
Poe v. Comm'r, T.C. Memo. 2005-107	Frivolous issues	Yes	IRS
Pollack v. U.S., , 327 F.Supp.2d 907 (W.D. Tenn. 2004)	Inability to argue TFRP liability, but procedure not followed	No	Split
Popky v. U.S., 326 F.Supp.2d 594 (E.D. Pa. 2004)	Request from third party not levy	No	IRS
Powers v. Comm'r, T.C. Summ. Op. 2005-21	Rejection of OIC as abuse	Yes	IRS
Prevo v. Comm'r, 123 T.C. 326 (2004)	Jurisdiction to hear case in bankruptcy	Yes	IRS
Quigley v. Comm'r, 358 F.Supp.2d 427 (E.D. Pa. 2004)	Face-to-face hearing requirement	Yes	IRS
Ramos v. U.S., 351 F.Supp.2d 5 (N.D. NY 2004)	Rejection of OIC as abuse	Yes	IRS
Ray v. Smith, 94 A.F.T.R.2d (RIA) 5925 (W.D. Mo. 2003)	Whether all procedures followed	Yes	IRS
Rewerts v. Comm'r, T.C. Memo. 2004-248	Frivolous issues	Yes	IRS
Roberts v. Comm'r, T.C. Summ. Op. 2005-40	Whether all payments made	Yes	IRS
Roberts v. Comm'r, T.C. Summ. Op. 2005-31	COD income belonged to TP, rejecting OIC as abuse	Yes	IRS
Robinette v. Comm'r, 123 T.C. 85 (2004), appeal docketed, No. 04-4081 (8th Cir. Dec. 16, 2004)	Default of OIC as abuse, review of new evidence	No	TP
Rustam v. Comm'r, T.C. Memo. 2005-42	Filed TFRP appeal in wrong court	No	IRS
Salza v. U.S., 2005 WL 149813 (E.D. Wis. 2005)	Lack of jurisdiction	Yes	IRS
Schroeder v. Comm'r, T.C. Memo. 2005-48	Appellate review as stay	Yes	IRS
Schultz v. U.S., 95 A.F.T.R.2d (RIA) 1977 (W.D. Mich. 2005)	Frivolous issues	Yes	IRS
Scibilia v. Comm'r, T.C. Memo. 2005-79	Inability to argue liability	Yes	IRS
Seavey v. Comm'r, T.C. Summ. Op. 2005-8	Reasonable cause on 6651 penalty	Yes	IRS
Sergio v. Comm'r, 95 A.F.T.R.2d (RIA) 1174 (N.D. Ga. 2005)	Proceeding with collection as abuse	Yes	IRS
Shireman v. Comm'r, T.C. Memo. 2004-155	Whether all procedures followed	Yes	IRS
Siquieros v. U.S., 94 A.F.T.R.2d (RIA) 5518 (W.D. Tex.. 2004)	Rejection of OIC as abuse	Yes	IRS
Simmons v. U.S., 95 A.F.T.R.2d (RIA) 1981 (N.D. Ga. 2005)	Lack of CDP notice	Yes	IRS
Skrizowski v. Comm'r, T.C. Memo. 2004-229	Abuse to reject OIC	No	TP
Smith v. Comm'r, 124 T.C. 36 (2005)	Jurisdiction when case in bankruptcy	No	TP
Snyder v. Comm'r, T.C. Memo. 2005-89	Frivolous issues	Yes	IRS
Speltz v. Comm'r, 124 T.C. 165 (2005)	Rejection of OIC as abuse	No	IRS
Splawn v. U.S., 95 A.F.T.R.2d (RIA) 5628 (E.D. Tenn. 2004)	Rejection of OIC as abuse	No	IRS
Stevens v. Comm'r, T.C. Dckt. No. 16710-04S (Feb. 8, 2005)	Jurisdiction no determination issued	Yes	IRS
Talen v. Comm'r, 355 F.Supp.2d 22 (D. D.C. 2004)	Inability to argue liability in TFRP case	No	IRS
Tate v. Comm'r, T.C. Dckt. No. 11923-04S (March 16, 2005)	Proceeding with collection as abuse	Yes	IRS
Taylor v. Comm'r, T.C. Memo. 2005-74	Frivolous issues	Yes	IRS
Taylor v. Comm'r, 95 A.F.T.R.2d (RIA) 2413 (9th Cir. 2005)	Failure to appear at CDP hearing	No	IRS
Thompson v. Comm'r, T.C. Memo. 2004-204	IRS failure to record as abuse	Yes	IRS
Thorpe v. Comm'r, T.C. Summ. Op. 2004-98	Strict adherence to Form 8857 as abuse, rejection of CNC as abuse	Yes	Split
Tinnerman v. Comm'r, 95 A.F.T.R.2d (RIA) 2401 (M.D. Fla. 2005)	Failure to provide face-to-face as abuse	No	IRS
Torczon v. Lucas, 95 A.F.T.R.2d (RIA) 681 (9th Cir. 2005)	Filed appeal in wrong court	Yes	IRS
Turner v. U.S., 372 F.Supp.2d 1053 (S.D. Ohio 2005)	Failure to provide face-to-face as abuse	Yes	IRS
Updegrave v. U.S., 94 A.F.T.R.2d (RIA) 6155 (D. Or. 2005)	Filed appeal in wrong court	Yes	IRS
Van Dyke v. Comm'r, T.C. Summ. Op. 2005-5	Collection statute of limitations	Yes	IRS
Vierow v. Comm'r, T.C. Memo. 2004-255	Location of hearing as abuse	Yes	IRS
Whiting v. Comm'r, T.C. Memo. 2004-136	Phone conversations as CDP hearing	No	IRS
Williams v. Comm'r, T.C. Memo. 2005-94	Frivolous issues	Yes	IRS
Yazzie v. Comm'r, T.C. Memo. 2004-233	Frivolous issues	Yes	IRS

TABLE 1: APPEALS FROM COLLECTION DUE PROCESS HEARINGS UNDER IRC §§ 6320 AND 6330 (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
Zachry v. Comm'r, T.C. Summ. Op. 2005-55	Innocent spouse relief	Yes	IRS
Zapara v. Comm'r, 124 T.C. 223 (2005)	Failure to sell stock as directed	Yes	Split
Zarcone v. U.S., 94 A.F.T.R.2d (RIA) 5470 (N.D. Cal. 2004)	Jurisdiction to compel accepting OIC	Yes	IRS
Zarcone v. U.S., 94 A.F.T.R.2d (RIA) 6210 (N.D. Cal. 2004)	Reconsideration of opinion	Yes	IRS
Zelaya v. Comm'r, T.C. Summ. Op. 20040-163	Liability attributable to duplicate refund	Yes	TP
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)			
Allglass Systems Inc. v. U.S., 330 F.Supp.2d 540 (E.D. Pa. 2004)	Failure to inform of CDP hearing, rejection of OIC as abuse	No	IRS
Alliance Services, Inc. v. U.S., 363 F.Supp.2d 1367 (N.D. Ga. 2005)	Rejection of OIC as abuse, RCP	No	IRS
American Bethel Corp. v. U.S., 94 A.F.T.R.2d (RIA) 5994 (W.D. Va. 2004)	Refusal to suspend collection as abuse	No	IRS
Barrett v. Comm'r, T.C. Summ. Op. 2004-128	Inability to raise liability per agreement	Yes	IRS
Christopher Cross, Inc. v. U.S., 95 A.F.T.R.2d (RIA) 1970 (E.D. La. 2005)	Non-processable OIC as abuse	No	IRS
Christopher Cross, Inc. v. U.S., 95 A.F.T.R.2d (RIA) 1322(E.D. La. 2004)	Returning OIC as abuse	No	IRS
Comfort Health Care, Inc. v. Comm'r, 2005 WL 1656914 (D. Minn. 2005)	Inability to argue liability, impartiality of Appeals officer	No	IRS
Cox v. U.S., 345 F.Supp.2d 1215 (W.D. Okla. 2004)	Inadequate notice of hearing, rejection of OIC	No	TP
Electro, Inc. v. Comm'r, 95 A.F.T.R.2d (RIA) 700 (D. Or. 2005)	Late service of complaint	No	TP
Enos v. Comm'r, 123 T.C. 284 (2004)	33 year old liability not extinguished due to 3rd party levy	No	IRS
Francis Harvey & Sons, Inc. v. U.S., 94 A.F.T.R.2d (RIA) 7258 (D. Mass. 2004)	Inability to challenge liability, evidence as to reasonable cause	No	IRS
Keesh Construction Co., Inc. v. U.S., 94 A.F.T.R.2d (RIA) 6477 (S.D. Ohio 2004)	Moot-bankruptcy	No	IRS
Landel Corp. v. U.S., 95 A.F.T.R.2d (RIA) 2001 (W.D. Wash. 2005)	Failure to consider IA as abuse	No	IRS
Living Care Alternatives of UTICA, Inc. v. U.S., 411 F.3d 621 (6th Cir. 2004)	Not considering OIC as abuse	No	IRS
Munguia Printers, Inc. v. U.S., 95 A.F.T.R.2d (RIA) 1355 (W.D. Tex. 2005)	Inability to argue liability	No	IRS
Newstat v. Comm'r, T.C. Memo. 2004-208	Inability to argue liability, no record addressing 1999 liability	Yes	Split
Perry v. U.S., 94 A.F.T.R.2d (RIA) 5623 (E.D. N.C. 2004)	Adequate CDP notice	Yes	IRS
Reid & Reid, Inc. v. U.S., 366 F.Supp.2d 284 (D. Md. 2005)	Rejecting IA as abuse	No	IRS
Winters v. Comm'r, T.C. Memo. 2005-3	Substantiating liability argument	Yes	IRS

TABLE 2
GROSS INCOME UNDER IRC § 61 AND RELATED SECTIONS

Case Cite	Issue(s)	*Pro Se*	Decision
Individual TPs (Issues Other Than Business)			
Abeid v. Comm'r, 122 T.C. No. 24	Lottery winnings of nonresident aliens	No	IRS
Abeyta v. Comm'r, T.C. Summ. Op. 2005-44	Lodging exclusion IRC § 119	Yes	IRS
Ali v. Comm'r, T.C. Memo. 2004-284	Constructive dividends	No	IRS
Arvin v. Comm'r, T.C. Summ. Op. 2004-108	Unreported income/frivolous argument	Yes	IRS
Barkley v. Comm'r, T.C. Memo. 2004-287	Retirement income	Yes	IRS
Bien-Aime v. Comm'r, T.C. Summ. Op. 2004-175	Unreported income	Yes	IRS
Bolden v. Comm'r, T.C. Summ. Op. 2004-114	Settlement income IRC § 104(a)(2)	Yes	IRS
Brooks v. US, 383 F.3d 521 (6th Cir. 2004)	Settlement income IRC § 104(a)(2)	No	IRS
Bruecher v. Comm'r, T.C. Summ. Op. 2005-52	Constructive dividends	No	IRS
Bunker v. Comm'r, T.C. Summ. Op. 2005-35	Insurance proceeds paying credit card debts are income	Yes	IRS
Buras v. Comm'r, T.C. Summ. Op. 2004-161	Retirement income	Yes	IRS
Bussell v. Comm'r, T.C. Memo. 2005-77	Constructive dividends	Yes	IRS
Castleton v. Comm'r, T.C. Memo. 2005-58	Unreported income	Yes	TP
Cawvey v. Comm'r, T.C. Summ. Op. 2005-63	Social Security versus Workers' Compensation IRC § 86(d)(3)	Yes	IRS
Chamberlain v. Comm'r, 401 F.3d 335 (5th Cir. 2005)	Prejudgment interest is not excluded from income under IRC § 104(a)(2)	No	IRS
Cohen v. Comm'r, T.C. Memo. 2004-227	Retirement income	No	IRS
Comm'r v. Banks, 125 S.Ct. 826	Settlement income under IRC § 104(a)(2) — Contingent attorney fee awards not excluded	No	IRS
Corrigan v. Comm'r, T.C. Memo. 2005-119	Unreported income/Discharge of indebtedness	Yes	Split
Davis v. Comm'r, T.C. Summ. Op. 2005-61	Social Security income	Yes	IRS
Delaware Corp. v. Comm'r, T.C. Memo. 2004-280	Constructive dividends	No	IRS
Dirks v. Comm'r, T.C. Memo. 2004-138	Retirement income (60-day rollover requirement not waived)	No	IRS
Dotson v. Comm'r, T.C. Summ. Op. 2004-164	Retirement income/Alimony IRC § 71	Yes	TP
Doxtator v. Comm'r, T.C. Memo. 2005-113	Compensation from Indian tribe/Unreported income	Yes	IRS
Dunkin v. Comm'r, 124 T.C. No. 10	Exclusion for community property divorce payments	Yes	TP
Filer v. Comm'r, T.C. Summ. Op. 2005-39	Annuity income/Oral trust	Yes	TP
Flores v. Comm'r, T.C. Summ. Op. 2005-57	Social Security versus Workers' Compensation IRC § 86(d)(3)	Yes	IRS
Ford v. Comm'r, T.C. Memo. 2005-18	Unreported income	No	IRS
Francisco v. Comm'r, 370 F.3d 1228 (D.C. Cir. 2004)	International Waters income	No	IRS
Hamilton v. Comm'r, T.C. Memo. 2004-161	Lottery winnings	Yes	IRS
Hayden v. Comm'r, 95 A.F.T.R.2d 1918 (9th Cir. 2005)	Disability income IRC § 105	No	IRS
Headen v. Comm'r, T.C. Summ. Op. 2005-33	Social Security income	Yes	IRS
Henderson v. Comm'r, 94 A.F.T.R.2d 5246 (9th Cir. 2004)	Settlement income IRC § 104(a)(2)	Yes	IRS
Hintz v. Comm'r, T.C. Summ. Op. 2005-43	Disability pension income IRC § 104(b)(3)	Yes	IRS
Hurst v. Comm'r, 124 T.C. No. 2	Sale of S Corporation/Health insurance premiums	No	Split
Jombo v. Comm'r, 398 F.3d 661 (D.C. Cir. 2005)	Constructive receipt of lottery winnings under IRC § 451	Yes	IRS
Jondahl v. Comm'r, T.C. Memo. 2005-55	Unreported income	No	Split
Jones v. U.S., 355 F.Supp.2d 1292 (S.D. Ala. 2004)	Ordinary Income versus capital gain	No	IRS
Kean v. Comm'r, 407 F.3d 186 (3d. Cir. 2005)	Alimony IRC § 71	No	IRS
Kellum v. Comm'r, T.C. Summ. Op. 2005-29	Worker's Compensation versus wages	Yes	IRS

TABLE 2

GROSS INCOME UNDER IRC § 61 AND RELATED SECTIONS (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
Kidd v. Comm'r, T.C. Memo. 2004-135	Settlement Income IRC § 104(a)(2)	Yes	IRS
Klingaman v. Comm'r, T.C. Summ. Op. 2005-36	Gambling income/Social Security	Yes	IRS
Kooyers v. Comm'r, T.C. Memo. 2004-281	Ponzi scheme victims income	Yes	TP
Lenzen v. Comm'r, T.C. Memo. 2005-120	Constructive Dividends	No	IRS
Lewis v. Comm'r, T.C. Memo. 2005-111	Unreported Income	Yes	IRS
Malfatti v. Comm'r, T.C. Memo. 2005-19	Unreported Income	Yes	IRS
Menard, Inc. v. Comm'r, T.C. Memo. 2004-207	Constructive Dividends/Constructive Receipt of Interest	No	IRS
Mitchell v. Comm'r, T.C. Summ. Op. 2004-160	Retirement Income	Yes	IRS
Molina v. Comm'r, T.C. Memo. 2004-258	Income from 401(k) Loan IRC § 72(p)	Yes	TP
Moran v. Comm'r, T.C. Memo. 2005-66	Constructive Dividends	Yes	IRS
Morrison v. Comm'r, T.C. Memo. 2005-53	Constructive Dividends	No	TP
Murphy v. I.R.S., 362 F.Supp. 2d 206 (D.D.C. 2005)	Settlement Income IRC § 104(a)(2)	No	IRS
Namyst v. Comm'r, T.C. Memo. 2004-263	Unreported Income	No	IRS
Ndirika v. Comm'r, T.C. Memo. 2004-250	Settlement Income IRC § 104(a)(2)	Yes	IRS
Ngatuvai v. Comm'r, T.C. Summ. Op. 2004-143	Discharge of Indebtedness IRC § 108	Yes	IRS
Ogu v. Comm'r, T.C. Summ. Op. 2004-87	Unreported Stock Sale Proceeds	Yes	IRS
Olson v. Comm'r, T.C. Memo. 2004-197	Retirement Income	No	IRS
Owens v. Comm'r, T.C. Summ. Op. 2004-102	Gifts versus Taxable Compensation	Yes	IRS
Peters v. Comm'r, T.C. Summ. Op. 2005-42	Retirement Income	Yes	IRS
Petty v. Comm'r, T.C. Memo. 2004-144	Gambling Income	Yes	IRS
Pickering v. Comm'r, T.C. Summ. Op. 2004-136	Unreported Income	Yes	IRS
PK Ventures, Inc. v. Comm'r, T.C. Memo. 2005-56	Constructive Dividends	No	TP
Polonczyk v. Comm'r, T.C. Summ. Op. 2005-66	Unreported Income	Yes	Split
Quarterman v. Comm'r, T.C. Memo. 2004-241	Interest Income	No	IRS
Reimels v. Comm'r, 123 T.C. No. 13	Disability/retirement income not excluded under IRC § 104(a)(4)	Yes	IRS
Revolinski v. Comm'r, T.C. Summ. Op. 2005-26	Life insurance surrender proceeds	Yes	IRS
Rodriguez v. Comm'r, 95 A.F.T.R.2d 1723 (9th Cir. 2005)	Unreported income	Yes	IRS
Rodriguez v. Comm'r, T.C. Memo. 2005-12	Unreported income/Frivolous argument	Yes	IRS
Seidel v. Comm'r, T.C. Memo. 2005-67	Taxation of Distribution of 401(k) in a divorce settlement	Yes	Split
Seidel v. Comm'r, T.C. Summ. Op. 2005-51	Taxation of distribution of 401(k) in a divorce settlement	Yes	Split
Sternberg v. I.R.S., 95 A.F.T.R.2d 402 (2d Cir. 2005)	Retirement income	Yes	IRS
Strong v. Comm'r, T.C. Memo. 2005-125	Unreported income/Constructive dividends	No	IRS
Taibo v. Comm'r, T.C. Memo. 2004-196	Johnston island	No	TP
Trent v. U.S., 372 F.Supp.2d (S.D.W.Va. 2005)	Settlement income IRC § 104(a)(2)	No	IRS
Valia v. Comm'r, T.C. Summ. Op. 2005-17	Settlement income IRC § 104(a)(2)	Yes	IRS
Vincent v. Comm'r, T.C. Memo. 2005-95	Settlement income IRC § 104(a)(2)	No	IRS
Werts v. Comm'r, T.C. Summ. Op. 2005-24	Social Security income	Yes	IRS
White v. Comm'r, T.C. Summ. Op. 2005-62	Retirement income	Yes	IRS
Widemon v. Comm'r, T.C. Memo. 2004-162	Retirement income	Yes	IRS
Williams v. Comm'r, 95 A.F.T.R.2d 764 (10th Cir. 2005)	Gifts versus taxable compensation	No	IRS
Williams v. Comm'r, T.C. Memo. 2005-29	Settlement income (Attorney's fees) IRC § 104(a)(2)	No	IRS

TABLE 2
GROSS INCOME UNDER IRC § 61 AND RELATED SECTIONS (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
Wolman v. Comm'r, T.C. Memo. 2004-262	Sale of lottery winnings is ordinary income, not a capital gain	Yes	IRS
Wright v. Comm'r, T.C. Memo. 2005-5	Disability income IRC § 105	No	IRS
Youngblood v. Comm'r, T.C. Memo. 2005-43	Disability/Retirement income not excluded under IRC § 104(a)(1)	No	IRS
Business TPs (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Business Trusts)			
Acle v. Comm'r, T.C. Summ. Op. 2004-82	Unreported income	Yes	IRS
Benson v. Comm'r, T.C. Memo. 2004-272	Constructive dividends/Discharge of Indebtedness income	No	IRS
Blanning v. Comm'r, T.C. Memo. 2004-201	Unreported income	Yes	IRS
Brenner v. Comm'r, T.C. Memo. 2004-202	Unreported income/Frivolous argument	Yes	IRS
Chin v. Comm'r, T.C. Memo. 2004-189	Unreported income	No	TP
CMA Consolidated, Inc. v. Comm'r, T.C. Memo. 2005-16	Assignment of income	No	IRS
Coccia v. Comm'r, T.C. Summ. Op. 2004-159	Unreported income	Yes	IRS
Coomes v. Comm'r, T.C. Memo. 2004-182	Unreported income	Yes	IRS
Edwards v. Comm'r, T.C. Memo. 2005-52	Unreported income	Yes	IRS
Gouveia v. Comm'r, T.C. Memo. 2004-256	Unreported income/Sham trusts	No	IRS
Gowni v. Comm'r, T.C. Memo 2004-154	Unreported Income, constructive dividends, capital gain basis	No	Split
Gracia v. Comm'r, T.C. Memo. 2004-147	Discharge of indebtedness IRC § 108	No	TP
Graham v. Comm'r, T.C. Memo. 2005-68	Unreported income	No	Split
Greene v. U.S., 62 Fed.Cl. 418	Taxation of insurance company's policyholders surplus account	No	IRS
Kikalos v. U.S., 408 F.3d 900 (7th Cir. 2005)	Unreported income	No	TP
Knauss v. Comm'r, T.C. Memo. 2005-6	Settlement income/unreported income	No	Split
Mas One Limited Partnership v. Comm'r, 390 F.3d 427 (6th Cir. 2004)	Partnership income/Discharge of debt	No	IRS
McGraw v. Comm'r, 384 F.3d 965 (8th Cir. 2004)	Reconstructing Income IRC § 446(b)	No	IRS
Mirarchi v. Comm'r, T.C. Memo. 2004-148	Discharge of indebtedness IRC § 108	No	TP
Payne v. Comm'r, T.C. Memo. 2005-130	Unreported income	No	IRS
Price v. Comm'r, T.C. Memo. 2004-149	Discharge of indebtedness IRC § 108	No	TP
Rinn v. Comm'r, T.C. Memo. 2004-256	Unreported income/Frivolous argument	Yes	IRS
Starkovich v. Comm'r, T.C. Summ. Op. 2004-173	Unreported income	Yes	IRS
Westby v. Comm'r, T.C. Memo. 2004-179	Unreported income	Yes	TP
Estates and Trusts			
Estate of Martinez v. Comm'r, T.C. Memo. 2004-150	Discharge of indebtedness IRC § 108	No	TP

TABLE 3
FAILURE TO FILE PENALTY UNDER IRC § 6651(A)(1)

Case Cite	Issue(s)	*Pro Se*	Decision
Individual TPs (Issues Other Than Business)			
Appel v. Comm'r, T.C. Summ. Op. 2004-90	Medical problems not reasonable cause	Yes	IRS
Arvin v. Comm'r, T.C. Summ.Op. 2004-108	Zero income return not a tax return for purposes of penalty	Yes	IRS
Barkley v. Comm'r, T.C. Memo. 2004-287	Job stress and medical problems of family member not reasonable cause	Yes	IRS
Basile v. Comm'r, T.C. Memo. 2005-51	TPs failed to appear at trial	Yes	IRS
Benedetti v. Comm'r, T.C. Summ. Op. 2005-6	"Zero income" return not a tax return for purposes of penalty	Yes	IRS
Berry v. Comm'r, T.C. Memo. 2005-91	Inability to assemble necessary documentation in time to file	No	IRS
Bowen v. Comm'r, 95 A.F.T.R. 2d (RIA) 2009 (9th Cir. 2005)	There is a legal obligation to file & pay federal income taxes	Yes	IRS
Brenner v. Comm'r, T.C. Memo. 2004-202	There is legal obligation to file & pay federal income taxes/ no evidence presented to show reasonable cause	Yes	IRS
Brunner v. Comm'r, T.C. Memo. 2004-187	No evidence as to reasonable cause	Yes	IRS
Buras v. Comm'r, T.C. Summ. Op. 2004-161	No legal obligation to file or pay federal income taxes	Yes	IRS
Chu v. Comm'r, T.C. Memo. 2005-110	Unavailability of records as reasonable cause	Yes	IRS
Conner v. Comm'r, T.C. Summ. Op. 2005-27	No evidence to show reasonable cause	Yes	IRS
Currier v. Comm'r, T.C. Memo. 2005-21	Claim of no tax liability under the law	Yes	IRS
Desauguste v. Comm'r, T.C. Summ. Op. 2005-60	No evidence to show reasonable cause	Yes	IRS
DiFlora v. Comm'r, T.C. Summ. Op. 2004-101	No evidence as to reasonable cause	Yes	IRS
Dysle v. Comm'r, T.C. Memo. 2004-285	No evidence presented to show tax returns were filed	Yes	IRS
Florance v. Comm'r, T.C. Memo. 2005-60	No evidence as to reasonable cause	Yes	IRS
Franklin v. Comm'r, T.C. Summ. Op. 2004-126	No evidence presented to substantiate claim that tax return timely filed	Yes	IRS
Funk v. Comm'r, 123 T.C. 213 (2004)	IRS does not have initial burden of proof on solely frivolous claims	Yes	IRS
Golshani v. Comm'r, T.C. Summ. Op. 2004-174	No evidence as to reasonable cause	No	IRS
Gowni v. Comm'r, T.C. Memo. 2004-154	No evidence as to reasonable cause	No	IRS
Graham v. Comm'r, T.C. Memo. 2005-68	Reliance on automatic extension as reasonable cause when estimate of liability not made with extension request	No	IRS
Graves v.Comm'r, T.C. Memo. 2004-140	Unavailability of information because of pending bankruptcy proceeding as reasonable cause	Yes	IRS
Greendyk v. Comm'r, T.C. Memo. 2005-108	No evidence as to reasonable cause	No	IRS
Gropper v. United States, 95 A.F.T.R.2d (RIA) 1926 (E.D. Pa. 2005)	Genuine issue of material fact as to whether the TP's medical condition constituted reasonable cause	No	TP
Halcott v. Comm'r, T.C. Memo. 2004-214	Zero income return not a tax return for purposes of penalty	Yes	IRS
Harris v. Comm'r, T.C. Summ. Op 2004-85	TP was able to meet her burden of proof and show that her tax return was filed timely.	Yes	TP
Jaroff v. Comm'r, T.C. Memo. 2004-276	Extensions of time to file invalid/no evidence presented as to reasonable cause	No	IRS
Kellum v. Comm'r, T.C. Summ. Op. 2005-29	No evidence as to reasonable cause	Yes	IRS
Lawless v. Comm'r, T.C. Summ. Op. 2005-18	Self-serving testimony as to filing return deemed insufficient	Yes	IRS
Lewis v. Comm'r, T.C. Memo. 2005-111	No evidence as to reasonable cause	Yes	IRS
Lykes v. Comm'r, T.C. Memo. 2004-159	Marital difficulty/illness of spouse/military duty as reasonable cause	Yes	IRS
Malfatti v. Comm'r, T.C. Memo. 2005-19	No evidence as to reasonable cause	Yes	IRS
Maloney v. Comm'r, T.C. Memo. 2005-27	Self-serving testimony about filing return insufficient	No	IRS
Mason v. Comm'r, T.C. Memo. 2004-247	Failure to file was fraudulent	Yes	IRS
Milby v. Comm'r, T.C. Memo. 2005-15	TP's obligation to file return	Yes	IRS
Ndirika v. Comm'r, T.C. Memo. 2004-250	No evidence as to reasonable cause	Yes	IRS

TABLE 3: FAILURE TO FILE PENALTY UNDER IRC § 6651(A)(1) (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
O'Laughlin v. Comm'r, T.C. Summ. Op. 2004-79	Physical injuries from car accident as reasonable cause	Yes	IRS
Olson v. Comm'r, T.C. Memo. 2004-234	No evidence as to reasonable cause	Yes	IRS
Pickering v. Comm'r, T.C. Summ. Op. 2004-136	No evidence as to reasonable cause	Yes	IRS
Preston v. Comm'r, T.C. Summ. Op. 2005-64	Neglecting/forgetting to file as reasonable cause	Yes	IRS
Quarterman v. Comm'r, T.C. Memo. 2004-241	Reliance on Spouse to file	No	IRS
Robinson v. Comm'r, T.C. Memo. 2005-70	No evidence presented as to reasonable cause	Yes	IRS
Rodriguez v. Comm'r, T.C. Memo. 2005-12	No evidence as to reasonable cause	Yes	IRS
Rodriguez v. Comm'r, 95 A.F.T.R. 2d (RIA) 1723 (9th Cir. 2005), aff'g T.C. Memo. 2003-105	No evidence as to reasonable cause	Yes	IRS
Rollins v. Comm'r, T.C. Memo. 2004-260	Belief that excise returns were not required to be filed	Yes	IRS
Sawukaytis v. Comm'r, 93 A.F.T.R.D.2d (RIA) 2847 (6th Cir. 2004), aff'g T.C. Memo. 2002-156	No evidence presented as to reasonable cause	Yes	IRS
Seavey v. Comm'r, T.C. Summ. Op. 2005-8	No evidence as to reasonable cause	Yes	IRS
Spanier v. Comm'r, T.C. Summ. Op. 2004-106	Protesting obligation to file	Yes	IRS
Storaasli v. Comm'r, T.C Memo. 2005-59	No evidence as to reasonable cause	Yes	IRS
Strong v. Comm'r, T.C. Memo. 2005-125	No evidence as to reasonable cause	No	IRS
Turner v. Comm'r, T.C. Memo. 2004-251	Zero income return not a return for purposes of penalty	Yes	IRS
Wesley v. United States, 95 A.F.T.R. 2d (RIA) 1832 (N.D. Fla. 2005)	Reliance on professional plus illness as reasonable cause	No	Split
Westby v. Comm'r, T.C. Memo. 2004-179	Reliance on spouse unreasonable	Yes	IRS
Widemon v. Comm'r, T.C. Memo. 2004-162	No evidence on reasonable cause	Yes	IRS
Business TPs (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships, Estates and Trusts)			
Allnutt v.Comm'r, T.C. Memo. 2004-239	TP engaged in taxable activity/had obligation to file	Yes	IRS
Benson v. Comm'r, T.C. Memo. 2004-272	Reliance on guardian to file return as reasonable cause	No	IRS
Biazar v. Comm'r, T.C. Memo. 2004-270	As to some years, TP provides no evidence, as to others IRS cannot prove when return was received	Yes	Split
Bijlani v. Comm'r, T.C. Summ. Op. 2004-96	Medical illness not reasonable cause	Yes	IRS
Bruecher v. Comm'r, T.C. Summ. Op. 2005-52	Reliance on tax professional to file an extension as reasonable cause	No	IRS
Donald's Electric & Refrigeration Service, Inc. v. United States, 95 A.F.T.R. 2d (RIA) 1398 (W.D. Va. 2005)	Mental illness of employee in charge of tax matters as reasonable cause	No	IRS
Dworshak v. Comm'r, T.C. Memo. 2004-249	Busy with business activities as reasonable cause	Yes	IRS
Estate of Korby v. Comm'r, T.C. Memo. 2005-102	No argument for reasonable cause made	No	IRS
Edwards v. Comm'r, T.C. Memo. 2005-52	Amount of income as reasonable cause	Yes	IRS
Ellis v. Comm'r, T.C. Summ. Op. 2004-170	No evidence presented as to reasonable cause	Yes	IRS
Ferrada v. Comm'r, T.C. Summ. Op. 2004-93	No evidence presented as to reasonable cause	Yes	IRS
Howard-Crowley v. Comm'r, T.C. Summ. Op. 2004-150	No evidence as to reasonable cause presented	Yes	IRS
Landers v. Comm'r, T.C. Summ. Op. 2004-105	No evidence presented as to reasonable cause	Yes	IRS
Matthews v. Comm'r, T.C. Summ. Op. 2004-89	No evidence presented as to reasonable cause	No	IRS
McGrath v. United States, 94 A.F.T.R.2d (RIA) 6138 (D. Ore. 2004)	Reliance on agent insufficient	Yes	IRS
Montague v. Comm'r, T.C. Memo. 2004-252	No evidence presented as to reasonable cause	Yes	IRS
Moran v. Comm'r, T.C. Memo. 2005-66	No evidence presented as to reasonable cause	Yes	IRS
Rinn v. Comm'r, T.C. Memo. 2004-246	No evidence presented as to reasonable cause	Yes	IRS
Rosa v. Comm'r, T.C. Summ. Op. 2005-53	No evidence presented	Yes	IRS
Walz v. Comm'r, T.C. Summ. Op. 2005-1	No evidence presented as to reasonable cause	No	TP

TABLE 4
TRADE OR BUSINESS EXPENSES UNDER IRC § 162 AND RELATED SECTIONS

Case Cite	Issue(s)	*Pro Se*	Decision
Sole Proprietors			
Alacan v. Comm'r, T.C. Memo. 2005-63	TPs failed to substantiate expenses	Yes	IRS
Applegage v. Comm'r, T.C. Summ. Op. 2004-113	Unreimbursed expense incurred in capacity as corporate officer denied	Yes	IRS
Aregoni v. Comm'r, T.C. Summ. Op. 2005-65	TP failed to substantiate expenses	Yes	IRS
Arevalo v. Comm'r, 124 T.C. 244 (2005)	TPs denied depreciation deduction for pay phones	Yes	IRS
Barton v. Comm'r, T.C. Memo. 2005-97	TP denied deduction for auto expenses for failure to substantiate	No	IRS
Bernardo v. Comm'r, T.C. Memo. 2004-199	TP failed to substantiate tax preparation fees and music performance activity not done for profit	Yes	IRS
Blanning v. Comm'r, T.C. Memo. 2004-201	TP failed to substantiate deductions, but court employed Cohan rule	Yes	TP
Brody v. Comm'r, T.C. Summ. Op. 2004-149	TP failed to substantiate vehicle expense and failed to prove he operated a trade or business	Yes	IRS
Calarco v. Comm'r, T.C. Summ. Op. 2004-94	Playwright engaged in playwriting for profit, but failed to properly substantiate many of his business expenses	Yes	Split
Chu v. Comm'r, T.C. Memo. 2005-110	Unreimbursed employee expenses denied	Yes	IRS
Coccia v. Comm'r, T.C. Summ. Op. 2004-159	TP denied expenses for operating newsstand for failure to substantiate	Yes	IRS
Corrigan v. Comm'r, T.C. Memo. 2005-119	Stock commission rebates allowable deduction, but casualty loss denied and deduction for horse breeding activity denied b/c TP was not a joint venturer	Yes	Split
Doxtator v. Comm'r, T.C. Memo. 2005-113	TP did not conduct business activity w/ continuity and regularity, did not have profit motive, and failed to substantiate casualty losses	Yes	IRS
Dumond v. Comm'r, T.C. Summ. Op. 2005-11	TP denied deduction for wages paid to minor children as not reasonable compensation and lack of substantiation	Yes	IRS
Ellis v. Comm'r, T.C. Summ. Op. 2004-170	TP denied deductions for failure to substantiate	Yes	IRS
Evan v. Comm'r, T.C. Memo. 2004-180	TPs not in trade/business w/ continuity and regularity and failed to substantiate expenses	Yes	IRS
Ferrada v. Comm'r, T.C. Summ. Op. 2004-93	TPs failed to substantiate deductions and failed to prove expenses were ordinary and necessary	Yes	IRS
Franklin v. Comm'r, T.C. Summ. Op. 2004-126	TP could not substantiate job search expenses and was unemployed for more than a reasonable temporary period	Yes	IRS
Garcia v. Comm'r, T.C. Supp. Op. 2005-2	TPs denied expenses relating to employment as high school teachers that were not ordinary & necessary	Yes	IRS
Giles v. Comm'r, T.C. Memo. 2005-28	Horse breeding not done for profit	No	IRS
Hopkins v. Comm'r, T.C. Memo. 2005-49	TPs denied advertising expenses that were not reasonable	No	IRS
Horwath v. Comm'r, T.C. Memo. 2004-213	TPs improperly depreciated property owned by a corporation that TPs were shareholders in and TP denied travel expense deduction because entitled to reimbursement by employer but chose not to be reimbursed	Yes	IRS
Howard-Crowley v. Comm'r, T.C. Summ. Op. 2004-150	TP denied deductions for failure to substantiate	Yes	IRS
Hubbard v. Comm'r, T.C. Summ. Op. 2004-148	TP denied bad debt deduction in connection with his personal security activity and denied business meeting and telephone expenses for lack of substantiation	Yes	IRS
Kellum v. Comm'r, T.C. Summ. Op. 2005-29	TP denied casualty loss deduction because insurance claim had reasonable prospect of recovery and denied expenses for insurance activity for failure to substantiate	Yes	IRS
Lapid v. Comm'r, T.C. Memo. 2004-222	TPs were not material participants in hotel business	No	IRS

TABLE 4 TRADE OR BUSINESS EXPENSES UNDER IRC § 162 AND RELATED SECTIONS (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
Lopez v. Comm'r, 94 A.F.T.R.2d (RIA) 7075 (5th Cir. 2004)	Amway distributors did not have profit motive	Yes	IRS
Malone v. Comm'r, T.C. Memo. 2005-69	TPs not in trade or business of giving music lessons	Yes	IRS
Matthews v. Comm'r, T.C. Summ. Op. 2004-89	Rodeo and horse training activity not done for profit	Yes	IRS
McEuen v. Comm'r, T.C. Summ. Op. 2004-107	Education qualified TP for a new trade or business and expense therefore not deductible	Yes	IRS
McNair v. Comm'r, T.C. Summ. Op. 2004-115	TP failed to substantiate business travel expenses and some tax preparation fees, cell phone charges, and postage	Yes	Split
Missouri v. Comm'r, T.C. Summ. Op. 2004-118	TP failed to substantiate employee business expenses	Yes	IRS
Montagne v. Comm'r, T.C. Memo. 2004-252	Horse breeding not done for profit	Yes	IRS
Moran v. Comm'r, T.C. Memo. 2005-66	Beauty shop owner fraudulently deducted alleged expenses	Yes	IRS
Mullins v. U.S., 334 F. Supp. 2d 1042	Cattle farm operated with profit objective	No	TP
Oatman v. Comm'r, T.C. Memo. 2004-236	TP improperly calculated depreciation deduction for rental property	Yes	Split
Ollett v. Comm'r, T.C. Summ. Op. 2004-103	Amway activity not done for profit	Yes	IRS
Panages v. Comm'r, T.C. Summ. Op. 2005-3	TP denied gambling losses because she didn't pursue gambling full-time	Yes	IRS
Rivera v. Comm'r, T.C. Summ. Op. 2004-81	Rental of real estate not done for profit	Yes	IRS
Rosa v. Comm'r, T.C. Summ. Op. 2005-53	TP failed to substantiate expenses	Yes	IRS
Saffran v. Comm'r, T.C. Summ. Op. 2004-152	TP denied deductions for failure to substantiate	Yes	IRS
Sax v. Comm'r, T.C. Summ. Op. 2004-171	TP denied deductions for failure to substantiate	Yes	IRS
Seidel v. Comm'r, T.C. Memo. 2005-67	TP failed to substantiate expenses	Yes	IRS
Setyono v. Comm'r, T.C. Summ. Op. 2004-127	TP failed to substantiate expenses	Yes	IRS
Sundby v. Comm'r, T.C. Summ. Op. 2004-104	TPs failed to substantiate deductions and some trade or business expenses should have been claimed by corporation rather than individuals	Yes	IRS
Tigrett v. U.S., 358 F. Supp. 2d 672	Court denied both parties' request for summary judgment	No	Split
Walz v. Comm'r, T.C Summ. Op. 2005-1	TP denied some deductions for failure to substantiate	No	Split
Westby v. Comm'r, T.C. Memo. 2004-179	Disallowance of law practice deductions was arbitrary and unreasonable	Yes	TP
Whalen v. Comm'r, T.C. Summ. Op. 2005-45	TP denied deductions for expenses that could have been reimbursed by employer and for failure to substantiate	Yes	IRS
Wheir v. Comm'r, T.C. Summ. Op. 2004-117	TP entitled to deduct travel and transportation expenses but not entitled to deduct certain expenses for body building activity that were not useful only in body building business	Yes	Split
Wilkerson v. Comm'r, T.C. Summ. Op. 2004-99	TP could not substantiate deductions and forfeiture of rights under collective bargaining agreement is not a deductible loss	Yes	IRS
Wood v. Comm'r, T.C. Memo. 2004-200	TPs held not to be carrying on a real estate developing business	Yes	IRS
Business Entities			
Beiner, Inc. v. Comm'r, T.C. Memo. 2004-219	Employee compensation was reasonable	No	TP
Edwards v. Comm'r, T.C. Memo. 2005-52	TP denied deduction for rent because expense was not ordinary and necessary	Yes	IRS
Hackworth v. Comm'r, T.C. Memo. 2004-173	TP denied loss deduction for money forfeited to state during raid of illicit gambling operation	No	IRS
Knauss v. Comm'r, T.C. Memo. 2005-6	S Corp's deductions denied when expenses were for personal benefit of shareholders	No	IRS
Lenzen v. Comm'r, T.C. Memo. 2005-120	TP was denied gambling losses	No	IRS

TABLE 4 TRADE OR BUSINESS EXPENSES UNDER IRC § 162 AND RELATED SECTIONS (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
Maguire/Thomas Partners v. Comm'r, T.C. Memo. 2005-34	TP allowed depreciation deduction for variance associated with building, but not for zoning change expenses in general	No	Split
Mediaworks v. Comm'r, T.C. Memo. 2004-177	Deduction for yacht-related expenses denied because they were not ordinary and necessary	No	IRS
Menard, Inc. v. Comm'r, T.C. Memo. 2004-207, motion for reconsideration denied, T.C. Memo. 2005-3	TP denied deduction for portion of employee compensation that was unreasonable	No	IRS
Metro Leasing v. Comm'r, 376 F.3d 1015 (9th Cir. 2004)	Excessive employee compensation	No	IRS
Miller & Sons Drywall, Inc. v. Comm'r, T.C. Memo. 2005-114	TP's compensation to employee-shareholders held to be reasonable, and thus fully deductible	No	TP
Mires v. U.S., 372 F. Supp. 2d 1265	TP failed to substantiate legal expenses	No	IRS
Payne v. Comm'r, T.C. Memo. 2005-130	S corporation denied deduction for check-cashing expenses because they were not ordinary and necessary business expenses	No	IRS
PK Ventures v. Comm'r, T.C. Memo. 2005-56	Employee comp deduction limited to reasonable comp, which was higher than IRS previously allowed, but lower than what TP claimed	No	Split
Shirley v. Comm'r, T.C. Memo. 2004-188	TP allowed § 179 deduction for purchase of a motor home to be added to a rental fleet	No	TP
Strong v. Comm'r, T.C. Memo. 2005-125	TP allowed deductions for advertising, but denied all other deductions for lack of substantiation	No	Split

TABLE 5
FRIVOLOUS ISSUES PENALTY UNDER IRC § 6673

Case Cite	Issues	*Pro Se*	Decision
Individual Taxpayers (Issues other than Business)			
Adams v. Comm'r, 127 Fed. Appx. 963 (9th Cir. 2005)	TPs argued that only corporate profit constitutes income subject to federal taxes	Yes	IRS
Arevalo v. Comm'r, 124 T.C. 244 (2005)	TP filed a Tax Court petition as a way to delay collection process	Yes	TP
Arvin v. Comm'r, T.C. Summ. Op. 2004-108	TP argued that the 16th Amendment did not give the Federal government new taxing authority and that income tax is really an excise tax on those licensed or incorporated	Yes	TP
Benedetti v. Comm'r, T.C. Summ. Op. 2005-6	TP argued that wages are property and not gross income	Yes	IRS
Boyd v. Comm'r, 121 Fed. Appx. 348 (10th Cir. 2005)	IRS's refusal to allow taxpayer to audio record hearing did not require remand	Yes	IRS
Brennecke v. Comm'r, T.C. Memo. 2005-11	TP raised frivolous arguments as to why he wasn't required to pay tax	Yes	IRS
Brunner v. Comm'r, T.C. Memo. 2004-187	TP raised arguments under the 4th, 5th, 9th, 13th, and 16th Amendments as to why he wasn't required to file a return	Yes	IRS
Buras v. Comm'r, T.C. Summ. Op. 2004-161	TP argued that he was an agent of the church and since the church was not taxable his wages should not be either	Yes	IRS
Burke v. Comm'r, 124 T.C. 189 (2005)	TP argued that notice of deficiency was invalid	Yes	IRS
Cardona v. Comm'r, 94 A.F.T.R.2d (RIA) 7148 (2d Cir. 2004)	TP argued the notice of lien didn't comply with procedural requirements and therefore was deprived of due process	Yes	IRS
Casey v. Comm'r, T.C. Memo. 2004-228	TP argued that IRS attorney's communications were vexatious and burdensome and subject to sanction under IRC § 6673(a)(2)	Yes	IRS
Chase v. Comm'r, T.C. Memo. 2004-142	TP claimed that the federal government had no jurisdiction over him	Yes	IRS
Cozzens v. Comm'r, T.C. Memo. 2005-98	IRS's refusal to allow taxpayer to audio record hearing does not require remand	Yes	TP
Currier v. Comm'r, T.C. Memo. 2005-21	TP offered common frivolous arguments as to why notice of deficiency was invalid and why he didn't owe tax	Yes	IRS
Dalton v. Comm'r, T.C. Memo. 2005-7	TP argued that notice of deficiency was invalid	Yes	TP
Dashiell v. Comm'r, T.C. Memo. 2004-210	TPs argued that their income was not includable in gross income	Yes	TP
Dues v. Comm'r, T.C. Memo. 2005-109	IRS's refusal to allow taxpayer to audio record hearing did not require remand	Yes	TP
Florance v. Comm'r, T.C. Memo. 2005-60	TP argued that he should not be considered a taxpayer	Yes	IRS
Florance v. Comm'r, T.C. Memo. 2005-61	TP argued that he should not be considered a taxpayer	Yes	IRS
Funk v. Comm'r, 123 T.C. 213 (2004)	TP argued that he is not considered a TP, the IRS has no jurisdiction over him, and the IRS has no statutory authority to collect taxes	Yes	TP
Gatlos v. Comm'r, T.C. Memo. 2004-192	TPs argued that the Commissioner had to sign the notice of intent to levy, the 16th Amendment is unconstitutional, and the Secretary has no authority to collect tax	Yes	IRS
Gavigan v. Comm'r, T.C. Summ. Op. 2004-155	TP argued that there was no law that required her to pay taxes and forcing people to pay them was slavery	Yes	IRS
Gilligan v. Comm'r, T.C. Memo. 2004-194	TP only challenged existence of law taxing earnings	Yes	IRS
Greendyk v. Comm'r, T.C. Memo. 2005-108	Neither TP nor his attorney submitted frivolous documents or briefs to the court	No	TP
Hamzik v. Comm'r, T.C. Memo. 2004-223	TP argued that he is not a taxpayer, and he has no earnings that may be taxed	Yes	IRS
Henderson v. Comm'r, T.C. Memo. 2004-157	TP argued that the Secretary had to sign the notice of deficiency	Yes	IRS
Hiland v. Comm'r, T.C. Memo. 2004-225	TP submitted lengthy communications to the court and incorrectly applied cases and the tax code	Yes	IRS
Hobbs v. Comm'r, 94 A.F.T.R.2d (RIA) 6194 (9th Cir. 2004)	TPs made frivolous arguments and had been previously warned of the possibility of sanctions	Yes	IRS
Holguin v. Comm'r, 94 A.F.T.R.2d (RIA) 5803 (9th Cir. 2004)	TP raised numerous frivolous issues in collection due process hearings solely for purpose of delay	Yes	IRS

TABLE 5: FRIVOLOUS ISSUES PENALTY UNDER IRC § 6673 (CONT.)

Case Cite	Issues	*Pro Se*	Decision
Howard v. Comm'r, T.C. Memo. 2005-144	TP argued that being paid is not a taxable event	Yes	IRS
Howard v. Comm'r, T.C. Memo. 2005-100	TP argued wages are not income	Yes	IRS
Johnston v. Comm'r, T.C. Memo. 2004-224	TP submitted lengthy communications to the court and misapplied the law	Yes	IRS
Kaplowitz v. Comm'r, T.C. Memo. 2005-62	TP argued that he was denied the opportunity to dispute the existence or amount of his tax liability	Yes	IRS
Kilgore v. Comm'r, T.C. Memo. 2005-24	TP argued she was not a taxpayer and the Commissioner needed to provide statute and Constitutional Amendments that allow for an income tax	Yes	IRS
Kolker v. Comm'r, T.C. Memo. 2004-288	TP argued that there was no law requiring him to pay income tax	Yes	IRS
Krueger v. Comm'r, T.C. Memo. 2005-105	TP argued that wages were not taxable income	Yes	IRS
Kubon v. Comm'r, T.C. Memo. 2005-71	TP argued that wages are not income and that notice of determination was insufficient	Yes	IRS
Le Doux v. Comm'r, 94 A.F.T.R.2d (RIA) 5013 (10th Cir. 2004)	TP argued notice of deficiency invalid because not signed by the Secretary	Yes	IRS
Lehmann v. Comm'r, T.C. Memo. 2005-90	TP argued notice of deficiency was invalid because he didn't receive it	Yes	IRS
Malfatti v. Comm'r, T.C. Memo. 2005-19	TP argued that liabilities are excise taxes, and TP failed to meet with the IRS or provide any of the requested information	Yes	IRS
Mathews v. Comm'r, T.C. Memo. 2005-84	TP offered only frivolous arguments that the IRS was committing a fraud against him	Yes	TP
Mathis v. United States, 94 A.F.T.R.2d (RIA) 6340 (D. S.D. 2004)	TPs instituted IRC § 7433 wrongful collection action but knew their claims had been rejected in previous cases	Yes	IRS
McBride v. Comm'r, T.C. Memo. 2004-178	TP argued the income tax was unconstitutional	Yes	TP
Meyer v. Comm'r, T.C. Memo. 2005-81	TPs primarily used the administrative hearings to delay the collection process, making frivolous arguments – including that the IRC doesn't establish tax liability	Yes	IRS
Meyer v. Comm'r, T.C. Memo. 2005-82	TPs primarily used the administrative hearings to delay the collection process, making frivolous arguments – including that the IRC doesn't establish tax liability	Yes	IRS
Milby v. Comm'r, T.C. Memo. 2005-15	TP argued that the IRS had not met the burden of proof	Yes	IRS
Olson v. Comm'r, T.C. Memo. 2004-234	TP argued that his wages were nontaxable	Yes	TP
Poe v. Comm'r, T.C. Memo. 2005-107	TP raised frivolous arguments related to IRS procedure that were primarily for delay	Yes	IRS
Rewerts v. Comm'r, T.C. Memo. 2004-248	TP argued that the notice of deficiency must be signed by the Secretary of the Treasury	Yes	TP
Rodriguez v. Comm'r, T.C. Memo. 2005-12	TP argued he did not receive an opportunity to challenge the IRS's evidence presented at trial	Yes	IRS
Sawukaytis v. Comm'r, 93 A.F.T.R.2d (RIA) 2847 (6th Cir. 2004)	TP argued federal income tax is an excise tax	No	IRS
Shireman v. Comm'r, T.C. Memo. 2004-155	TP argued that the IRS had to rely on a particular document to verify that applicable laws and procedures have been met for a Collection Due Process hearing	Yes	TP
Sides v. Comm'r, T.C. Memo. 2004-141	TP made frivolous arguments in petition but at trial admitted arguments were inappropriate and promised not to raise these frivolous arguments again	Yes	TP
Smith v. Comm'r, T.C. Memo. 2004-198	TP failed to appear at trial and then offered frivolous arguments for delay of collection process	Yes	TP
Snyder v. Comm'r, T.C. Memo. 2005-89	IRS's refusal to allow taxpayer to audio record hearing does not require remand	Yes	TP
Stearman v. Comm'r, T.C. Memo. 2005-39	TP argued that there is no such thing as income tax and that the 16th Amendment is unconstitutional	Yes	IRS
Stephanatos v. Comm'r, T.C. Memo. 2004-151	TP made frivolous arguments concerning improper deductions and whether wages are taxable income	Yes	IRS
Storaasli v. Comm'r, T.C. Memo. 2005-59	TP argued that the federal government did not have the authority to enforce a federal income tax and that notice of deficiency was improper	Yes	IRS

TABLE 5: FRIVOLOUS ISSUES PENALTY UNDER IRC § 6673 (CONT.)

Case Cite	Issues	*Pro Se*	Decision
Taylor v. Comm'r, T.C. Memo. 2005-74	TP argued notice of deficiency was invalid	Yes	IRS
Tello v. Comm'r, 95 A.F.T.R.2d (RIA) 1916 (5th Cir. 2005), cert. denied, 126 S.Ct. 381 (Oct. 3, 2005)	TP failed to cooperate with IRS and ignored warnings to stop making frivolous arguments	Yes	IRS
Thompson v. Comm'r, T.C. Memo. 2004-204	TP argued that notice of deficiency was invalid because not signed by Secretary or his delegate	Yes	TP
Williams v. Comm'r, T.C. Memo. 2005-94	TP submitted lengthy communications to the court and misapplied tax law, court decisions, and Constitutional provisions	Yes	IRS
Wos v. Comm'r, 94 A.F.T.R.2d (RIA) 6195 (7th Cir. 2004)	TP argued that profit from business is not income, no liability because he didn't receive valid assessment, and IRS didn't have authority to prepare return	Yes	IRS
Yazzie v. Comm'r, T.C. Memo. 2004-233	TP argued that no law established liability for income taxes or required her to file a return	Yes	IRS
Business Taxpayers (Sole Proprietorships including Schedule C or F, Schedule E, Corporations, Partnerships, and Trusts)			
Brenner v. Comm'r, T.C. Memo. 2004-202	TP raised frivolous arguments ranging from communism to separation of church and state	Yes	IRS
Rinn v. Comm'r, T.C. Memo. 2004-246	TPs' court filings were frivolous and were warned at trial about the penalty but filed no brief and didn't continue to pursue those arguments after trial	Yes	TP
Sinele v. Comm'r, T.C. Memo. 2004-137	TP offered new argument on the eve of trial for the purpose of delaying the proceedings	No	IRS

TABLE 6
NEGLIGENCE PENALTY UNDER IRC § 6662(B)1

Case Cite	Issue(s)	*Pro Se*	Decision
Individual Taxpayers (Issues Other Than Business			
Abeyta v. Comm'r, T.C. Summ. Op. 2005-44	TPs (H&W) reasonably relied on tax professional	Yes	TPs
Bien-Aime v. Comm'r, T.C. Memo. 2004-281	TP failed to carefully review tax return prepared by advisor	Yes	IRS
Bolden v. Comm'r, T.C. Summ. Op. 2004-114	TP did not inquire about the accuracy of her tax return	Yes	IRS
Bosco v. Comm'r, T.C. Summ. Op. 2005-14	TP intentionally disregarded information from her employer regarding payment of moving expenses/TP's reliance on advisor regarding deductibility of moving expenses was reasonable	Yes	Split
Cohen v. Comm'r, T.C. Memo. 2004-227	Not receiving a Form 1099-R is not reasonable cause	No	IRS
DiFlora v. Comm'r, T.C. Summ. Op. 2004-101	TP provided no evidence to show reasonable cause	Yes	IRS
Golshani v. Comm'r, T.C. Summ. Op. 2004-174	TPs (H&W) reasonably attempted to comply with the tax code	No	TPs
Gowni v. Comm'r, T.C. Memo. 2004-154	TPs (H&W) did not reasonably rely on the tax professional/ did not keep adequate books & records	No	IRS
Graves v. Comm'r, T.C. Memo. 2004-140	TPs (H&W) did not keep adequate books & records/did not attempt to ascertain correctness of deduction	Yes	IRS
Howard-Crowley v. Comm'r, T.C. Summ. Op. 2004-150	TP provided no evidence to show reasonable cause	Yes	IRS
Namyst v. Comm'r, T.C. Memo. 2004-263	W-2, but H&W reasonably attempted to comply with the tax law based on information available	No	TPs
Reimann v. Comm'r, T.C. Summ. Op. 2005-10	TPs (H&W) did not make sufficient effort to ascertain correct tax liability/did not consult a tax professional.	Yes	IRS
Spanier v. Comm'r, T.C. Summ. Op. 2004-106	No reasonable basis for deductions — Court order allowing TP (H) to claim dependency exemptions not issued until after return was filed	Yes	Split
Stephanatos v. Comm'r, T.C. Memo. 2004-151	TP's arguments were frivolous	Yes	IRS
Taibo v. Comm'r, T.C. Memo. 2004-196	TP's reliance on a current income tax regulation was reasonable cause	No	TP
Turner v. Comm'r, T.C. Memo. 2004-251	TP's return containing zeroes was held to be invalid return	Yes	TP
Williams v. Comm'r, 95 A.F.T.R. 2d (RIA) 764 (10th Cir. 2005)	TP relied on incorrect W-2 when completing income tax return	No	IRS
Business Taxpayers (sole proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships, and Trust(s)).			
Acle v. Comm'r, T.C. Summ. Op. 2004-82	TP did not keep complete or adequate records	Yes	IRS
Allnutt v. Comm'r, T.C. Memo. 2004-239	TP's reliance on adviser not reasonable when complete/accurate records not provided	Yes	IRS
Barnes v. Comm'r, T.C. Memo. 2004-266	TP did not reasonably rely on tax professional	No	IRS
Beiner, Inc. v. Comm'r, T.C. Memo. 2004-219	TP exercised ordinary business care and prudence in determining deduction for officer compensation	No	TP
Benson v. Comm'r, T.C. Memo. 2004-272	TPs did not provide complete information to their tax professionals	No	IRS
Bernardo v. Comm'r, T.C. Memo. 2004-199	Reasonable reliance on tax professional/lack of substantiation	Yes	Split
Biazar v. Comm'r, T.C. Memo. 2004-270	TPs (H&W) failed to show reasonable cause for failure to maintain records of schedule C expenses	Yes	IRS
Calarco v. Comm'r, T.C. Summ. Op. 2004-94	TP did not exercise reasonable diligence to determine correctness of deductions/didn't keep accurate records	Yes	Split
Caspian Consulting Group, Inc. v. Comm'r, T.C. Memo. 2005-54	TP's reliance on tax professional was reasonable when TP gave professional all necessary records	No	TP
CMA Consolidated, Inc. v. Comm'r, T.C. Memo. 2005-16	TP could not reasonably rely on the tax professional when TP did not disclose all relevant facts	No	IRS
Corrigan v. Comm'r, T.C. Memo. 2005-119	TP unreasonably relied on attorney and did not keep adequate records	Yes	IRS
Delaware Corp. v. Comm'r, T.C. Memo. 2004-280	TP's reliance on tax professional not reasonable when correct information not provided	No	IRS
Doxtator v. Comm'r, T.C. Memo. 2005-113	TP's position regarding self-employment tax exemption was reasonable/TP failed to keep books & records to substantiate expenses	Yes	Split

TABLE 6: NEGLIGENCE PENALTY UNDER IRC § 6662(B)1 (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
Dumond v. Comm'r, T.C. Summ. Op. 2005-11	TP did not keep adequate records or otherwise substantiate deductions	Yes	IRS
Fairey v. Comm'r, T.C. Memo. 2005-129	TPs (H&W) failed to keep adequate records	Yes	ERS
Firsow v. Comm'r, T.C. Summ. Op. 2004-112	TPs (H&W) did not take reasonable steps to comply with the law/did not keep credible records	No	IRS
Gouveia v. Comm'r, T.C. Memo. 2004-252	TPs' reliance on tax avoidance scheme repeatedly rejected by the courts was not reasonable/TPs did not show that they relied on advice from a tax professional	No	IRS
Graham v. Comm'r, T.C. Memo. 2005-68	TP failed to show reasonable cause	No	IRS
Hansen v. Comm'r, T.C. Memo. 2004-269	TP did not reasonably rely on tax professional	No	IRS
Hitchen v. Comm'r, T.C. Memo. 2004-265	TP could not reasonably rely on the tax professional	Yes	IRS
Horwath v. Comm'r, T.C. Memo. 2004-213	No reasonable cause shown or good faith in computing the deductions	Yes	IRS
Hurst v. Comm'r, 124 T.C. 16 (2005)	TPs reasonably complied with the tax code	No	TPs
Kooyers v. Comm'r, T.C. Memo. 2004-281	TPs failed to prove their tax professional was competent	Yes	IRS
Lenzen v. Comm'r, T.C. Memo. 2005-120	TPs did not keep adequate records of their wins or losses from gambling	No	IRS
Malone v. Comm'r, T.C. Memo. 2005-69	TP was an educated individual but did not have tax expertise and reasonable minds could differ as to the tax treatment of complex issue	Yes	TP
McNair v. Comm'r, T.C. Summ. Op. 2004-115	TP did not review tax returns before filing/didn't keep adequate records	Yes	IRS
Mediaworks, Inc. v. Comm'r, T.C. Memo. 2004-177	TP's reliance on adviser not reasonable when adviser not competent	No	IRS
Menard, Inc. v. Comm'r, T.C. Memo. 2004-207	TPs did not provide their tax professional with complete and accurate records	No	IRS
Montagne v. Comm'r, T.C. Memo. 2004-252	TPs did not provide any evidence to show reasonable cause	Yes	IRS
Morrison v. Comm'r, T.C. Memo. 2005-53	Court held no underpayment of tax existed, so penalty not applicable	No	TP
Mortensen v. Comm'r, T.C. Memo. 2004-279	TP's reliance on promoters of the investment and other investors was not objectively reasonable	No	IRS
Oatman v. Comm'r, T.C. Memo. 2004-236	TPs (H&W) used improper methods to compute depreciation & didn't provide evidence to show reasonable cause	Yes	IRS
Ogu v Comm'r, T.C. Summ. Op. 2004-87	TP did not keep adequate books & records/did not substantiate	Yes	IRS
Panages v. Comm'r, T.C. Summ. Op. 2005-3	TP had a reasonable basis for believing that she was a professional gambler/kept accurate records	Yes	TP
Rahimi v. Comm'r, T.C. Summ. Op. 2004-156	TPs could not show reasonable cause	Yes	IRS
Starkovich v. Comm'r, T.C. Summ. Op. 2004-173	TP did not keep adequate records	Yes	IRS
Van Scoten v. Comm'r, T.C. Memo. 2004-275	TP's reliance on another investor in same partnership not objectively reasonable	No	IRS
Walz v. Comm'r, T.C. Summ. Op. 2005-1	TP reasonably relied on tax professional	No	TP
Westby v. Comm'r, T.C. Memo. 2004-179	TP kept complete and adequate records and could show reasonable cause	Yes	TP
Wood v. Comm'r, T.C. Memo. 2004-200	TP's deductions were improper, and he did not consult a tax professional	Yes	IRS

TABLE 7
FAMILY STATUS ISSUES UNDER IRC §§ 2,21,24,32,AND 151

Case Cite	Issue(s)	*Pro Se*	Decision
Individual TPs (Issues Other Than Business)			
Allsopp v. Comm'r, T.C. Summ. Op. 2004-154	Dependency Exemption, Child Tax Credit	Yes	IRS
Bernardo v. Comm'r, T.C. Memo. 2004-199	Dependency Exemption, Filing Status	Yes	IRS
Booker v. Comm'r, T.C. Summ. Op. 2004-92	Dependency Exemption, EITC, Filing Status	Yes	IRS
Bouch v. Comm'r, T.C. Summ. Op. 2004-167	Dependency Exemption, Child Tax Credit	Yes	IRS
Boulden v. Comm'r, T.C. Summ. Op. 2004-124	Dependency Exemption, Child Tax Credit	Yes	IRS
Brettin v. Comm'r, T. C. Summ. Op. 2004-95	Dependency Exemption, Child Tax Credit	No	IRS
Brunner v. Comm'r, T.C. Memo. 2004-187	Dependency Exemption	Yes	IRS
Caputi v. Comm'r, T.C. Memo. 2004-283	Dependency Exemption, Child Tax Credit, Filing Status	Yes	IRS
Castleton v. Comm'r, T.C. Memo 2005-58	Child Tax Credit, Filing Status	Yes	Split
Colstock v. Comm'r, T.C. Summ. Op. 2005-54	Dependency Exemption, Child Tax Credit, EITC, Filing Status	Yes	IRS
Corrigan v. Comm'r, T.C. Memo. 2005-119	Dependency Exemption	Yes	TP
Curello v. Comm'r, T.C. Summ. Op. 2005-23	Dependency Exemption, Child Tax Credit	Yes	IRS
Diaz v. Comm'r, T.C. Memo. 2004-145	EITC	Yes	IRS
Elkins v. Comm'r, T.C. Summ. Op. 2004-84	Dependency Exemption, Child Tax Credit, Filing Status, Child and Dependent Care Credit	Yes	Split
Emanie v. Comm'r, T.C. Summ. Op. 2004-78	Dependency Exemption, Filing Status	Yes	IRS
Howard-Crowley v. Comm'r, T.C. Summ. Op. 2004-150	Dependency Exemption	Yes	IRS
Hubbard v. Comm'r, T.C. Summ. Op. 2004-148	Filing Status, Child and Dependent Care Credit	Yes	TP
Hutchinson v. Comm'r, T.C. Summ. Op. 2005-58	Dependency Exemption	No	IRS
In re Adkins, 2004 WL 2334716 (Bankr. D. Kan. 2004)	Pro rata share of EITC is includible in bankruptcy estate	No	Trustee
In re James, 406 F.3d 1340 (11th Cir. 2005)	EITC is "public assistance" which debtors can claim as exemption under Alabama law.	No	TP
In re Schwarz, 314 B.R. 433 (D. Neb. 2004)	Portions of federal and state refunds attributable to child tax credit not included in bankruptcy estate.	No	TP
Jondahl v. Comm'r, T.C. Memo 2005-55	Filing Status	No	IRS
Jones v. Comm'r, T.C. Summ. Op. 2004-133	Dependency Exemption, EITC	Yes	IRS
Joseph v. Comm'r, T.C. Summ. Op. 2004-137	Dependency Exemption, EITC	Yes	IRS
Lear v. Comm'r, T.C. Memo 2004-253	Dependency Exemption, EITC	Yes	IRS
Mbachu v. Comm'r, T.C. Summ. Op. 2004-168	EITC, Filing Status	Yes	IRS
Mbanu v. Comm'r, T.C. Summ. Op. 2005-56	EITC, Filing Status	Yes	IRS
McNair v. Comm'r, T.C. Summ. Op. 2004-115	Dependency Exemption, Child Tax Credit, Child and Dependent Care Credit	Yes	IRS
Montwillo v. Comm'r, T.C. Summ. Op. 2004-123	Dependency Exemption, Child Tax Credit, Filing Status	Yes	IRS
Muncy v. Comm'r, T.C. Summ. Op. 2005-20	Dependency Exemption, Child Tax Credit, EITC, Filing Status	Yes	IRS
Myers v. Comm'r, T.C. Summ. Op. 2005-15	EITC	Yes	IRS
Ogu v. Comm'r, T.C. Summ. Op. 2004-87	EITC, Filing Status	Yes	IRS
Petty v. Comm'r, T.C. Memo 2004-144	EITC	Yes	IRS
Rogers v. Comm'r, T.C. Memo. 2004-245	EITC	Yes	IRS
Sampson v. Comm'r, T.C. Summ. Op. 2005-30	Dependency Exemption, EITC, Filing Status	Yes	IRS
Scott v. Comm'r, T.C. Summ. Op. 2004-129	Dependency Exemption, Child Tax Credit	Yes	IRS
Somsukcharean v. Comm'r, T.C. Summ. Op. 2005-49	Dependency Exemption, Child Tax Credit, EITC	Yes	IRS

TABLE 7: FAMILY STATUS ISSUES UNDER IRC §§ 2,21,24,32,AND 151 (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
Spanier v. Comm'r, T.C. Summ. Op. 2004-106	Dependency Exemption	Yes	Custodial Parent
Szasz v. Comm'r, T.C. Summ. Op. 2004-169	Dependency Exemption, Filing Status	Yes	IRS
Toney v. Comm'r, T.C. Memo. 2004-165	Dependency Exemption, EITC, Filing Status	Yes	IRS
Urena v. Comm'r, T.C. Summ. Op. 2004-138	EITC	Yes	IRS
Varner v. Comm'r, T.C. Summ. Op. 2004-111	Dependency Exemption, EITC, Filing Status	Yes	IRS
Wells v. Comm'r, T.C. Summ. Op. 2004-153	Dependency Exemption, Child Tax Credit	Yes	IRS
Wentland v. Comm'r, T.C. Summ. Op. 2004-134	Dependency Exemption	Yes	Split
Werther v. Comm'r, T.C. Summ. Op. 2005-28	Dependency Exemption, Child Tax Credit	Yes	IRS

TABLE 8
RELIEF FROM JOINT AND SEVERAL LIABILITY UNDER IRC § 6015

Case Cite	Issues	*Pro Se*	Intervenor	Decision
Abelein v. Comm'r, T.C. Memo. 2004-274, appeal docketed, No. 05-71672 (9th Cir. Mar. 7, 2005)	6015(b), (f); RP, §4.03	No	No	IRS
Albin v. Comm'r, T.C. Memo. 2004-230	6015(b),(c),(f); RP, §4.03	Yes	No	IRS
Alt v. Comm'r, 93 A.F.T.R.2d (RIA) 2561 (6th Cir. 2004), aff'g 119 T.C. 306 (2002)	6015(b),(c),(f); RP, §4.03	No	No	IRS
Barnes v. Comm'r, T.C. Memo. 2004-266	6015(b),(c),(f); RP, §4.03	No	No	IRS
Baumann v. Comm'r, T.C. Memo. 2005-31	TC determined H had sufficient opportunity to participate; 6015(f); RP, §4.03	No	No	IRS
Becherer v. Comm'r, T.C. Memo. 2004-282	6015(b), (c), (f); RP, §4.03	Yes	No	IRS
Bowen v. Comm'r, T.C. Summ. Op. 2005-32	6015(c) (IRS did not prove actual knowledge)	Yes	No	TP
Bussell v. Comm'r, T.C. Memo. 2005-77	6015(b) and (c) (knowledge);RP, §4.01 (threshold condition/fraud)	Yes	No	IRS
Capehart v. Comm'r, T.C. Memo. 2004-268, appeal docketed, No. 05-71306 (9th Cir. Feb. 22, 2005)	6015(b),(c),(f); RP, §4.03	No	No	IRS
Coleman v. Comm'r, T.C. Summ. Op. 2004-165	IRS had conceded relief; TC sustained relief despite intervenor's objection	Yes	Yes	TP*
Cook v. Comm'r, T.C. Memo. 2005-22	6015(c) (IRS did not prove actual knowledge)	Yes	No	TP
Cullen v. Comm'r, T.C. Memo. 2004-176	6015(b),(c),(f)(knowledge); RP, §4.03	Yes	No	IRS
DeFore v. Comm'r, T.C. Summ. Op. 2004-162	6015(c) (IRS did not prove actual knowledge)	Yes	No	TP
Drake v. Comm'r, 123 T.C. 320 (2004)	Tax Court granted govt's motion to dismiss; held that automatic bankruptcy stay bars the filing of a petition in a 6015 standalone proceeding	No	No	IRS
Durham v. Comm'r, T.C. Memo. 2004-184	6015(b),(c),(f); RP, §4.03 (underpayment)	Yes	No	IRS
Ford v. Comm'r, T.C. Memo. 2005-18	6015(b) (knowledge or reason to know)	No	No	IRS
Friday v. Comm'r, 124 T.C. 220 (2005)	Tax Court denied IRS motion to remand case back to agency to make merits determination; no 6015 analog to CDP remand under the retained jurisdiction provision of 6330(d)	No	No	TP
George v. Comm'r, T.C. Memo. 2004-261	6015(f) (underpayment); RP, §4.03	Yes	No	IRS
Giles v. Comm'r, T.C. Summ. Op. 2004-145	6015(b),(c),(f) (knowledge or reason to know); RP, §4.03	Yes	No	IRS
Griffin v. Comm'r, T.C. Summ. Op. 2005-41	6015(f) (underpayment); RP, §4.03	Yes	No	IRS
Haag, U.S. v., 94 A.F.T.R.2d 6665 (D. Mass. 2004)	6015(b),(f) (timeliness of claim)	No	No	IRS
Hall v. Comm'r, T.C. Memo. 2004-170	6015(f) (timeliness of claim)	Yes	Yes	IRS
Hendricks v. Comm'r, T.C. Memo. 2005-72	6015(b) (no knowledge or reason to know)	No	No	TP
James v. Comm'r, T.C. Summ. Op. 2004-176	6015(f); RP, §4.03 (underpayment)	No	No	IRS
Jones v. Comm'r, T.C. Summ. Op. 2005-9	Denied relief in two years because tax fully paid prior to effective date of 6015; third year dismissed for lack of jurisdiction	Yes		IRS
Knorr v. Comm'r, T.C. Memo. 2004-212	6015(f); RP, §4.03 (underpayment)	No	Yes	IRS
Levy v. Comm'r, T.C. Memo. 2005-92	Denied 6015(b) based on reason to know; granted (c) relief based on govt's failure to proved actual knowledge; granted and denied (f) relief for various years based on factor analysis in RP, §4.03	No	No	Split
Lopez v. Comm'r, T.C. Memo. 2005-36	6015(f) (underpayment), RP §4.03	Yes	No	IRS
McClelland v. Comm'r, T.C. Memo. 2005-121	6015(b) (knowledge or reason to know)	No	No	TP
McGee v. Comm'r, 123 T.C. 314 (2004)	6015(f) Tax Court held that failure to notify TP of right to file claim for 6015 relief in refund offset notice as required by RRA98 § 3501 precludes any finding that the claim was untimely filed	Yes	No	TP

* The IRS conceded the 6015 issue prior to trial; the nonrequesting spouse intervened resulting in a trial and opinion favorable to the requesting spouse.

TABLE 8: RELIEF FROM JOINT AND SEVERAL LIABILITY UNDER IRC § 6015 (CONT.)

Case Cite	Issues	*Pro Se*	Intervenor	Decision
Monsour v. Comm'r, T.C. Memo. 2004-190	6015(b), (f), and (g)(2) TC held that TP had materially participated in the prior TC proceeding and was precluded by res judicata from raising an innocent spouse claim	No	No	IRS
Morello v. Comm'r, T.C. Memo. 2004-181	6015(f) (underpayment); RP, §4.03	Yes	No	IRS
Nelson v. Comm'r, T.C. Memo. 2005-9	6015(f) Tax Court held that failure to notify TP of right to file claim for 6015 relief in refund offset notice as required by RRA98 § 3501 precludes any finding that the claim was untimely filed	Yes		TP
Noons v. Comm'r, T.C. Memo. 2004-243	Res judicata	No	No	IRS
O'Neill v. Comm'r, T.C. Memo. 2004-183	6015(f) (underpayment); RP, §4.03	Yes	Yes	IRS
Payne v. Comm'r, T.C. Memo. 2005-130	6015(b),(c),(f) ;Reason to know; fraud	No	No	IRS
Pless v. Comm'r, 111 Fed. Appx. 178 (4th Cir. 2004), affg T.C. Memo. 2004-24	6015(f); RP, §4.03	Yes	No	IRS
Rivera v. Comm'r, T.C. Memo. 2005-33	6015(g); statute precludes refunds for relief granted under 6015(c)	Yes	No	IRS
Scarborough v. Comm'r, T.C. Summ. Op. 2004-116	6015(f) (underpayment); RP, §4.03	Yes	Yes	IRS
Sjodin v. Comm'r, T.C. Memo. 2004-205, appeal docketed, No. 05-1110 (8th Cir. Jan. 10, 2005)	6015(f) (underpayment); RP, §4.03	Yes	No	IRS
Taylor v. Comm'r, T.C. Summ. Op. 2005-48	6015(f) (underpayment); RP, §4.03	Yes	Yes	IRS
Thorpe v. Comm'r, T.C. Summ. Op. 2004-98	Tax Court remanded CDP case to IRS to consider TP's 6015(c) claim; AO's refusal to consider claim because it was not filed on Form 8857 was an abuse of discretion	Yes	No	TP
Van Arsdalen v. Comm'r, 123 T.C. 135 (2004)	Tax Court held that former spouse had right to intervene in support of requesting spouse's claim for relief	No	Yes	TP
Wang v. Comm'r, T.C. Summ. Op. 2004-113	6015(b), (f); RP, §4.03	Yes	No	IRS
Zachry v. Comm'r, T.C. Summ. Op. 2005-55	6015(b),(c),(f) (actual knowledge); RP, §4.03	Yes	Yes	IRS

TABLE 9
SUMMONS ENFORCEMENT UNDER IRC § 7604

Case Cite	Issue(s)	*Pro Se*	Decision
Individual TPs (Issues Other Than Business)			
Conner v. U.S., 94 A.F.T.R.2d (RIA) 7287 (W.D. Va. 2004).	7609(a)(1) notice timely; 6531 6 year limit does not prevent discovery; IRS does not already have records	No	IRS
Cranford v. U.S. 359 F.Supp.2d 981 (E.D. Cal. 2005).	TP's spouse not entitled to notice and did not have standing	No	IRS
Doe v. U.S., 398 F.3d 686 (5th Cir. 2005), rev'g Doe v. KPMG, LLP, 93 A.F.T.R.2d (RIA) 1808 (N.D. Tex. 2004).	Statute of limitations on assessment not extended by equitable tolling	No	TP
Edlund v. U.S., 95 A.F.T.R.2d (RIA) 1650 (D. Colo. 2005).	Powell requirements satisfied:, e.g. summons for legitimate purpose; data relevant; IRS does not have data already; summons procedures followed	No	IRS
English v. Krubsack, 371 F.Supp.2d 1198 (E.D. Cal. 2005).	Powell requirements satisfied	Yes	IRS
Green v. Bank One N.A., 95 A.F.T.R.2d (RIA) 2085 (E.D. Cal. 2005).	The Powel requirements were met and the arguments the plaintiff put forward were frivolous	Yes	IRS
Grenier v. U.S., 94 A.F.T.R.2d (RIA) 7116 (D. N.D. 2004).	Summons sufficiently narrow	No	IRS
Haydel v. U.S., 2005 WL 233805 (N.D. Tex. 2005)	Powell requirements were met	Yes	IRS
Hembree v. U.S., 95 A.F.T.R.2d (RIA) 2198 (M.D. Fla. 2005).	Powell requirements were met	Yes	IRS
Jewett v. U.S., 95 A.F.T.R.2d (RIA) 1846 (N.D. Ohio. 2005).	TP offered frivolous arguments against summons	Yes	IRS
Lintzenich v. U.S., 95 A.F.T.R.2d (RIA) 1169 (S.D. Ind. 2005).	Summons issued for legitimate purpose although general 3-year period for assessment has passed	No	IRS
Marks v. U.S., 94 A.F.T.R.2d (RIA) 7272 (N.D. Tex. 2004).	TP offers frivolous arguments	Yes	IRS
Ryerson v. I.R.S., 95 A.F.T.R.2d (RIA) 2100 (D. Ariz. 2005).	Powell requirements satisfied; 5th Amendment rights not violated	Yes	IRS
Schulz v. I.R.S., 395 F.3d 463 (2nd Cir. 2005), clarified by, *Schulz v. I.R.S.*, 413 F.3d 297 (2nd Cir. 2005).	TP has no standing to contest summons served on him until IRS attempts to enforce the summons	Yes	IRS
Sochia v. U.S., 94 A.F.T.R.2d 5502 (W.D. Tex. 2004).	TP offers frivolous arguments	Yes	IRS
Steiniger v. U.S., 95 A.F.T.R.2d (RIA) 1088 (E.D. Pa. 2005).	Powell requirements satisfied	Yes	IRS
Thomas v. U.S., 94 A.F.T.R.2d (RIA) 5015 (D. Me. 2004).	The Powell requirements were met and the TP's arguments were frivolous	Yes	IRS
Thompson-Perry v. U.S., 94 A.F.T.R.2d (RIA) 6862 (N.D. Ohio. 2004).	TP not entitled to notice, did not have standing; proceeding not timely	No	IRS
Tilley v. U.S., 95 A.F.T.R.2d (RIA) 1395 (5th Cir. 2005).	Lack of attestation does not invalidate summons	Yes	IRS
Tilley v. U.S., 94 A.F.T.R.2d (RIA) 6942 (M.D.N.C. 2004).	TP failed to file petition within 20 day period	Yes	IRS
U.S. v. Heubusch, 95 A.F.T.R.2d (RIA) 1066 (2nd Cir. 2005).	Documents improperly seized in criminal case can be summoned in civil case if IRS has independent knowledge	No	IRS
U.S. v. Hibben, 95 A.F.T.R.2d (RIA) 2055 (E.D. Ky. 2005); *US. v. Hibben*, 95 A.F.T.R.2d (RIA) 2063 (E.D. Ky. 2005).	Powell requirements met; TP offers frivolous arguments	Yes	IRS
U.S. v. Hubbard, 122 Fed.Appx. 868 (8th Cir. 2005).	Affirmed district court - IRS made prima facia case for summons enforcement	Yes	IRS
U.S. v. Milligan, 95 A.F.T.R.2d (RIA) 1994 (D. Ariz. 2005).	No Fifth Amendment privilege; in camera hearing denied	No	IRS
U.S. v. Norwood, 94 A.F.T.R.2d (RIA) 5933 (D. N.D. 2004); *U.S. v. Norwood*, 94 A.F.T.R.2d (RIA) 5938 (D. N.D. 2004); *U.S. v. Norwood*, 95 A.F.T.R.2d (RIA) 2470 (D. N.D. 2005).	No violation of Fourth or Fifth Amendment, discovery request is outside scope of summons proceeding	No	IRS
U.S. v. Olmer, 94 A.F.T.R.2d (RIA) 6482 (D. Neb. 2004).	Fifth Amendment not applicable to summons seeking nontestimonial data	Yes	IRS
U.S. v. Ott, 94 A.F.T.R.2d (RIA) 6558 (D. Kan. 2004).	Failure to comply with summons	Yes	IRS

TABLE 9: SUMMONS ENFORCEMENT UNDER IRC § 7604 (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
U.S. v. Pate, 94 A.F.T.R.2d (RIA) 5480 (5th Cir. 2004).	Affirmed district court holding that summonses were not issued solely for criminal investigation	No	IRS
U.S. v. Pelayo, 94 A.F.T.R.2d (RIA) 5034 (N.D. Cal. 2004).	Powell requirements were met	Yes	IRS
Business TPs (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships, Estates and Trusts)			
Belsby v. Comm'r, 95 A.F.T.R.2d (RIA) 400 (E.D. Wash. 2004).	Bank records relevant to determine tax liability Powell requirements met	Yes	IRS
Domestic Executive Leasing Services, LLC, v. U.S., 95 A.F.T.R.2d (RIA) 1966 (D. Nev. 2005).	Summonsed records were relevant	No	IRS
Estate of Reiserer v. U.S., 95 A.F.T.R.2d (RIA) 2660 (W.D. Wash. 2005).	Summons does not abate upon individual's death; client's identities are not privileged; summoned documents were relevant	No	IRS
U.S. v. B & D Vending, Inc., 398 F.3d 728 (6th Cir. 2004).	Affirmed district court, corporate documents not protected by the Fifth Amendment	No	IRS
U.S. v. BDO Seidman, LLP, 337 F.3d 802, 810-812 (7th Cir. 2003); *U.S. v. BDO Seidman, LLP*, 95 A.F.T.R.2d (RIA) 1725 (N.D. Ill. 2005); *U.S. v. BDO Seidman*, 368 F.Supp.2d 858 (N.D. Ill. 2005).	Some summonsed documents protected by attorney-client privilege. Court found crime-fraud exception prevented one document from being privileged	No	Split
U.S. v. Boulware, 350 F.Supp.2d 837 (D. Haw. 2004).	TP not entitled to intervene, no abuse of process	No	IRS
U.S. v. Brown, 95 A.F.T.R.2d (RIA) 1261 (N.D. Fla. 2005).	Court rejected jurisdictional arguments	Yes	IRS
U.S. v. Hayden, 95 A.F.T.R.2d (RIA) 815 (S.D. Cal. 2004).	Summons enforceable if for determining civil tax liability, even if documents may relate to the criminal investigation of another party	No	IRS
U.S. v. Judicial Watch, 371 F.3d 824 (D.C. Cir. 2004).	Affirmed district court holding that summons issued for legitimate purpose; no violation of First, Fourth, or Fifth Amendment	No	IRS
U.S. v. Kaiser, 397 F.3d 641 (8th Cir. 2005).	Affirmed district court holding that summonses not for improper purpose or in retaliation	No	IRS
U.S. v. Montgomery Global Advisors, LLC, 95 A.F.T.R.2d (RIA) 1997 (N.D. Cal. 2005).	Failure to comply with summons	No	IRS
U.S. v. Monumental Life Ins, 94 A.F.T.R.2d (RIA) 6487 (W.D. Ky. 2004).	Powell requirements met	No	IRS
Xelan, Inc v. U.S., 94 A.F.T.R.2d (RIA) 5217 (S.D. Iowa 2004).	Notice of summons does not need to be provided to all plan participants	No	IRS
Xelan, Inc v. U.S., 361 F.Supp.2d 459 (D. Md. 2005).	Powell requirements satisfied	No	IRS
Xelan, Inc v. U.S., 94 A.F.T.R.2d (RIA) 6755 (E.D. Pa. 2004).	Notice need not be provided to all plan participants; no criminal referral made	No	IRS

3

APPENDIX

TABLE 10
TRUST FUND RECOVERY PENALTY (TFRP) UNDER IRC § 6672

Case Cite	Issue(s)	*Pro Se*	Decision
Individual TPs (Issues Other Than Business)			
Ashworth v. United States, 95 A.F.T.R.2d (RIA) 2476 (D. N.J. 2005)	Responsibility determination for jury; willfulness found as a matter of law	No	Split
Austin v. Comm'r, 95 A.F.T.R.2d (RIA) 2304 (E.D. CA 2005)	TP's complaint untimely	Yes	IRS
Baimbridge v. United States, 335 F.Supp.2d 1084 (S.D. Cal. 2004)	Responsibility determination as matter of law; estoppel argument for trial	No	Split
In re Borman, 94 A.F.T.R.2d (RIA) 6301 (Bankr. S.D. Fla. 2004)	Instruction not to pay tax as defense	No	IRS
Brewer v. United States, 390 F.Supp.2d 1378 (S.D. Ga. 2005)	Equitable tolling principles do not apply when determining timeliness of TFRP refund suit	No	IRS
Dallin v. United States, 62 Fed. Cl. 589 (2004)	Whether IRS followed proper procedures when assessing TFRP	No	IRS
Currie v. Comm'r, 95 A.F.T.R.2d (RIA) 1961 (N.D. GA 2005)	TP cannot argue TFRP liability	Yes	IRS
Dewing v. United States, 95 A.F.T.R.2d (RIA) 1609 (D. Nev. 2005)	TP had no control or authority	No	TP
Ferguson v. United States, 94 A.F.T.R.2d (RIA) 6322 (S.D. Iowa 2004)	In action for attorneys fees, TFRP was justified against CEO but not controller	No	Split
In re Fiesole Trading Corp., 315 B.R. 198 (D. Mass. 2004)	6672 as a tax or as a penalty	No	TP
In re Frank, 322 B.R. 745 (M.D. N.C. 2005)	Notice as invalidating assessment; designating payments for trust fund as negating willfulness	Yes	Split
Glass v. United States, 335 F.Supp.2d 736 (N.D. Tex. 2004)	Assessment of TFRP not justified	No	TP
Gutherie v. United States, 359 F.Supp.2d 693 (E.D. Tenn. 2005)	Obligation of government to liquidate assets and apply them to trust fund liability during bankruptcy	Yes	IRS
Lencyk v. United States, 384 F.Supp.2d 1028 (W.D. Tex. 2005)	Responsibility and willfulness determination and impact of using surety company on determination	No	IRS
Lewis v. United States, 95 A.F.T.R.2d (RIA) 2752 (W.D. Tenn. 2005)	Issues raised are moot	No	IRS
Littriello v. United States, 95 A.F.T.R.2d (RIA) 2581 (W.D. Ky. 2005)	6672 as only means to assess tax against member of a limited liability company	No	IRS
*In re Lowthorp,*325 B.R. 470 (M.D. Fla. 2005)	Demand letters post discharge violated court order	No	TP
Jackling v. IRS, 352 F.Supp.2d 129 (D. NH 2004)	TP waived ability to argue TFRP liability	Yes	IRS
Jean v. U.S., 396 F.3d 449 (1st Cir. 2005)	Substantial basis for TFRP assessment	Yes	IRS
Killingsworth v. U.S., 94 A.F.T.R.2d (RIA) 6108 (5th Cir. 2004)	Expiration of refund statute	Yes	IRS
Lubetzky v. United States, 393 F.3d 76 (1st Cir. 2004)	Timing of responsible person status	No	IRS
Moran v. United States, 94 A.F.T.R.2d (RIA) 5840 (N.D. Ill. 2004)	Whether TFRP payments were made	No	IRS
Pollack v. U.S., 327 F.Supp.2d 907 (W.D. TN 2004)	TP responsible person, but TFRP procedure not followed	No	Split
In re Pugh, 315 B.R. 889 (D. Nev. 2004)	Responsible person but question of fact as to willfulness	No	Split
Rustam v. Comm'r, T.C. Memo. 2005-42	Petition to challenge TFRP liability filed in wrong court	No	IRS
Salzillo v. United States, 66 Fed. Cl. 23 (2005)	Responsibility determination	No	TP
Secret v. United States, 373 F.Supp.2d 619 (N.D. W. Va. 2005)	Responsibility determination for CPA	No	TP
Underberg v. United States, 362 F.Supp.2d 1278 (D. N.M. 2005)	Financing arrangement negating willfulness	No	IRS
United States v. Beltran, 316 B.R. 371 (S.D. Fla. 2004)	Subsequent cooperation in assisting IRS collect past due taxes as negating willfulness	No	IRS
United States v. Kraljevich, 364 F.Supp.2d 655 (E.D. Mich. 2005)	Responsibility and willfulness	Yes	IRS

TABLE 10: TRUST FUND RECOVERY PENALTY (TFRP) UNDER IRC § 6672 (CONT.)

Case Cite	Issue(s)	*Pro Se*	Decision
United States v. Scharringhausen, 95 A.F.T.R.2d (RIA) 825 (S.D. Cal. 2005)	Setting aside TFRP judgment where TP did not answer complaint	No	IRS
United States v. White, 325 B.R. 918 (N.D. Ga. 2005)	Effect of TFRP assessment made in violation of automatic stay	No	TP
Urban v. United States, 392 F.Supp.2d 1018 (N.D. Ill. 2005)	Effect of IRS loss of Waiver Extending Assessment Statute	No	IRS
In re Yeh, 94 A.F.T.R.2d (RIA) 5800 (Bankr. N.D. Ala. 2004)	Responsibility and willfulness determination	No	IRS

TAXPAYER ADVOCATE SERVICE

ACRONYM GLOSSARY

ACRONYM GLOSSARY - ANNUAL REPORT TO CONGRESS 2005

Acronym	Definition
ACDS	Appeals Centralized Database System
ACH	Automated Clearing House
ACS	Automated Collection System
ACTC	Advance Child Tax Credit
AEITC	Advanced Earned Income Tax Credit
AGI	Adjusted Gross Income
AICPA	American Institute of Certified Public Accountants
AIS	Automated Insolvency System
AJCA	American Jobs Creation Act of 2004
AIMS	Audit Information Management System
ALE	Allowable Living Expenses
ALS	Automated Lien System
AMT	Alternative Minimum Tax
ANMF	Automated Non Master File
AOIC	Automated Offer In Compromise
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
AWSS	Agency Wide Shared Services
BMF	Business Master File
CADE	Customer Account Data Engine
CARE	Customer Assistance, Relationships & Education
CAS	Customer Account Services
CAWR	Combined Annual Wage Reporting Program
CCISO	Cincinatti Centralized Innocent Spouse Operations
CCR	Central Contractor Registration
CDP	Collection Due Process
CDPTS	Collection Due Process Tracking System
CEX	Consumer Expenditure Survey
CFF	Collection Field Function
CERCA	Council for Electronic Revenue Communication Advancement
CID	Criminal Investigation Division
CIDS	Centralized Inventory Distribution System
CIP	Compliance Initiative Project
CNC	Currently Not Collectible
COIC	Centralized Offer In Compromise
COTR	Contract Officer Technical Representative
CONOPS	Concept of Operations
CPE	Continuing Professional Education
CQMS	Collection Quality Management System

ACRONYM GLOSSARY - ANNUAL REPORT TO CONGRESS 2005 (CONT.)

Acronym	Definition
CRIS	Compliance Research Information System
CSED	Collection Statute Expiration Date
CSR	Customer Service Representative
CTC	Child Tax Credit
DA	Disclosure Authorization
DATC	Doubt As To Collectibility
DATL	Doubt As To Liability
DDP	Daily Delinquency Penalty
DI	Desktop Integration or Debt Indicator
DIF	Discriminant Inventory Function
DPT	Dynamic Project Team
EAR	Electronic Account Resolution
EBT	Electronic Benefits Transfer
EDS	Exempt Determinations System
EFIN	Electronic Filing Identification Number
EFTPS	Electronic Federal Tax Payment System
EGTRRA	Economic Growth and Tax Relief Reconciliation Act
EIN	Employer Identification Number
EITC	Earned Income Tax Credit
ELS	Electronic Lodgment Service
EO	Exempt Organization
EP	Employee Plans
EQRS	Embedded Quality Review System
ERCS	Examination Returns Control System
ERIS	Enforcement Revenue Information System
ERO	Electronic Return Originator
ERSA	Employee Retirement Savings Account
ES	Estimated Tax Payments
ESA	Educational Savings Account
ESL	English as a Second Language
ETA	Electronic Tax Administration
ETACC	Electronic Tax Administration Advisory Committee
ETLA	Electronic Tax Law Assistance
FA	Field Assistance
FDC	Fraud Detection Center
FDCPA	Fair Debt Collection Practices Act
FICA	Federal Insurance Contribution Act
FMS	Financial Management Service
FOIA	Freedom Of Information Act
FPDC	Federal Procurement Data Center
FPDS	Federal Procurement Data System
FMV	Fair Market Value
FPLP	Federal Payment Levy Program

ACRONYM GLOSSARY - ANNUAL REPORT TO CONGRESS 2005 (CONT.)

Acronym	Definition
FTC	Federal Trade Commission
FTD	Federal Tax Deposit or Failure To Deposit
FTE	Full Time Equivalent
FTF	Failure To File
FTI	Federal Tax Information
FTP	Failure To Pay
FY	Fiscal Year
GAO	Government Accountability Office or General Accounting Office
GE	Government Entities
ICM	Intelligent Call Management
ICP	Integrated Case Processing
ICS	Integrated Collection System
IDFP	IRS Directory for Practitioners
IDRS	Integrated Data Retrieval System
IDS	Inventory Delivery System
IMF	Individual Master File
IPIA	Improper Payments Improvement Act
IRC	Internal Revenue Code
IRI	Incomplete Return Item
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
IRSAC	Internal Revenue Service Advisory Council
ISP	Industry Specialization Program
ISRP	Integrated Submission and Remittance Processing
ISTS	Innocent Spouse Tracking System
ITIN	Individual Taxpayer Identification Number
LEP	Limited English Proficiency
LITC	Low Income Taxpayer Clinic
LLC	Lifetime Learning Credit
LMSB	Large & Mid-Sized Business Operating Division
LOS	Level of Service
LRF	Last Return Filed
LSA	Lifetime Savings Account
LTA	Local Taxpayer Advocate
MAGI	Modified Adjusted Gross Income
MFT	Master File Transaction Code
MITS	Modernization and Information Technology Services
NFTL	Notice of Federal Tax Lien
NMF	Non-Master File
NPIIT	Notice Process Improvement Initiative Team
NRP	National Research Program
NSG	Notice Support Group
NTA	National Taxpayer Advocate

ACRONYM GLOSSARY - ANNUAL REPORT TO CONGRESS 2005 (CONT.)

Acronym	Definition
NUMIDENT	Number Identification Database
OAR	Operations Assistance Request
OASDI	Old-Age, Survivors, and Disability Insurance
OBRA	Omnibus Budget Reconciliation Act of 1989
OIC	Offer in Compromise
OMB	Office of Management and Budget
OPR	Office of Professional Responsibilitly
OPERA	Office of Program Evaluation, Risk, & Analysis
OPI	Office of Penalty and Interest Administration
PAF	Payer Account File
PDC	Private Debt Collection
POA	Power Of Attorney
PTIN	Preparer Tax Identification Number
QRP	Questionable Refund Program
RAC	Refund Anticipation Check
RACS	Revenue Accounting Control System
RAL	Refund Anticipation Loan
RCA	Reasonable Cause Assistant
RCP	Reasonable Collection Potential
RFQ	Request For Quotations
RGS	Report Generation System
ROFT	Record of Federal Tax
RRA 98	Internal Revenue Service Reform and Restructuring Act of 1998
RPS	Revenue Protection Strategy
RPP	Return Preparer Program
SAMS	Systemic Advocacy Management System
SAR	Strategic Assessment Report
SB/SE	Small Business/Self Employed Operating Division
SBJPA	Small Business Job Protection Act
SERP	Servicewide Electronic Research Program
SFR	Substitute for Return
SPEC	Stakeholder Partnerships, Education & Communication
SPOC	Single Point of Contact
SSA	Social Security Administration
SSI	Supplemental Security Income
SSN	Social Security Number
STARS	Scheme Tracking and Referral System
TAC	Taxpayer Assistance Center
TAMIS	Taxpayer Advocate Management Information System
TANF	Temporary Assistance to Needy Families
TAP	Taxpayer Advocacy Panel
TAS	Taxpayer Advocate Service
TCE	Tax Counseling for the Elderly

4

ACRONYM GLOSSARY - ANNUAL REPORT TO CONGRESS 2005 (CONT.)

Acronym	Definition
TCMP	Taxpayer Compliance Measurement Program
TDA	Taxpayer Delinquent Account
TDRA	Tip Rate Determination Agreement
TDI	Taxpayer Delinquency Investigation
TDQAS	Training Development Quality Assurance System
TDS	Transcript Delivery System
TEC	Taxpayer Education and Communication
TE/GE	Tax Exempt & Government Entities Operating Division
TFRP	Trust Fund Recovery Penalty
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number
TOP	Treasury Offset Program
TPDS	Third Party Data Store
TPI	Total Positive Income
TPNCs	Taxpayer Notice Codes
TRA 97	Taxpayer Relief Act of 1997
TRAC	Tip Reporting Alternative Commitment
TRIS	Telephone Routing Interactive System
UCH	Universal Case History
UI-DIF	Unreported Income Discriminant Function
VITA	Volunteer Income Tax Assistance
W & I	Wage and Investment Operating Division
WFTRA	Working Families Tax Relief Act
WIC	Women, Infants and Children

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Note: District of Columbia residents should contact the Baltimore Taxpayer Advocate Service at the following address, telephone, or FAX number until the D.C. office opens on May 1, 2006:

31 Hopkins Plaza, Room 940
Baltimore, MD 21201
Phone: 410-962-2082
FAX: 410-962-9340

Beginning May 1, 2006, taxpayers may visit the D.C. office at the following location, or contact the office by mail, telephone or FAX number:

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500 North Capital St. N.W.
Suite 1301
Washington, D.C. 20221
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