2009 Annual Report to Congress

National Taxpayer Advocate

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NATIONAL TAXPAYER ADVOCATE

2009 ANNUAL REPORT TO CONGRESS

Executive Summary: Preface & Highlights

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TAXPAYER ADVOCATE

IRS SERVICE

YOUR VOICE AT THE IRS

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Honorable Members of Congress:

I respectfully submit for your consideration the National Taxpayer Advocate's 2009 Annual Report to Congress. Section 7803(c)(2)(B)(ii) of the Internal Revenue Code requires the National Taxpayer Advocate to submit this report each year and in it, among other things, to identify at least 20 of the most serious problems encountered by taxpayers and to make administrative and legislative recommendations to mitigate those problems. Thus, the statute requires that the report focus on problems and areas in need of improvement.

For context, however, I believe that the IRS in many respects has had an extremely successful year. It has, through talent, determination, and dedication, pulled off what could have been a disastrous filing season, what with significant tax law changes enacted in the midst of the filing season. The IRS had no slack in implementing these new or expanded programs – including revising withholding tables for the Making Work Pay credit and quickly processing claims and amended returns for the First-Time Homebuyer Credit – which were designed to stimulate the sluggish economy. The IRS also faced less sweeping but notable challenges effectively, including its productive voluntary disclosure program for taxpayers holding offshore accounts and the guidance it quickly issued to assist victims of the devastating Madoff Ponzi scheme.[1]

From a taxpayer rights and consumer protection perspective, the IRS this year acted on two longstanding issues that I have identified several times as most serious problems of taxpayers – identity theft and automated levies on Social Security benefits. As described in this report's Status Updates, after a year of negotiations with the Taxpayer Advocate Service (TAS), the IRS's Identity Theft Hotline has now committed to handling taxpayers' cases and providing taxpayers with the kind of service – including coordination and oversight – that heretofore has only been available from TAS.[2] With respect to Social Security levies, after TAS published its study in last year's report showing that these automated levies under the Federal Payment Levy Program (FPLP) were harming vulnerable taxpayers,[3] the IRS – working with me and my research staff – is now programming a screen that will filter out taxpayers whose income is at or below 250 percent of the federal poverty level. When this screen is implemented in 2011, the IRS will protect hundreds of thousands of taxpayers from economic damage and unnecessary interaction with the IRS.[4] I am deeply grateful for the IRS's efforts on both these issues.

A major development in tax administration was the IRS's announcement, early in the year, that it would study the question of regulating federal return preparers and present a report to the President and the Secretary of the Treasury before year's end. I have recommended the regulation of unenrolled return preparers since my 2002 Annual Report to Congress, and reiterated and supplemented that recommendation in successive reports.[5] My office was very much involved in

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1 *See* Most Serious Problem: *Ponzi Schemes Present Challenges for Taxpayers and the IRS, infra.*

2 *See* Status Update: *IRS's Identity Theft Procedures Require Fine-Tuning, infra.*

3 *See* National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2 (Research Report: *Building a Better Filter: Protecting Lower Income Social Security Recipients from the Federal Payment Levy Program*).

4 *See* Status Update: *Federal Payment Levy Program: IRS Agrees to Low Income Taxpayer Filter, infra.*

5 *See* Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy, infra* (and prior National Taxpayer Advocate reports cited therein).

the analysis and discussions resulting in the IRS report, and I applaud Commissioner Shulman's leadership in undertaking this significant review. Because the IRS report has not been publicly released at the time our report is going to press, I am including our detailed analysis of the issues raised by any regulation of return preparers without generally commenting on the IRS report.[6]

IRS Successes Come at a Cost to Its Core Tax Administration Duties and Delay Improvements to IRS Practices That Would Benefit Taxpayers.

The IRS successes over the last year should not be understated. They do not, however, diminish the challenges that lie ahead for the IRS as it attempts to fulfill its core tax administration duties while at the same time facing an expanding role in delivering social benefit programs, including the social safety net, economic stimulus, and health care.[7] These challenges are best demonstrated by this year's number one most serious problem for taxpayers: the declining "level of service" for IRS toll-free lines.[8] During a time of great need for taxpayer assistance, the IRS's *goal* for fiscal year (FY) 2010 is to answer 71 percent of the calls from taxpayers who want to speak with an assistor (not a recording), down from 83 percent in FY 2007. In other words, the IRS is planning to be unable to answer about three out of every ten calls it receives. Moreover, those taxpayers that are able to get through to an assistor will have to wait, on average, twelve minutes. This level of service is unacceptable for taxpayers who require assistance, and it is sure to have downstream consequences that will cause problems for taxpayers and the IRS alike, as some taxpayers give up and don't bother to file or they make avoidable errors that the IRS then must devote resources toward resolving.

This year we continue to have concerns about the IRS Examination program. In past Annual Reports to Congress, we have encouraged the IRS to make "Increasing Voluntary Compliance" the overriding goal for all of its activities, including its compliance and enforcement actions.[9] Yet, in introducing and identifying six exam-related most serious problems, we note that the IRS often fails to design its exam initiatives to maximize voluntary compliance and instead takes a one-off approach that creates burden on taxpayers and uses IRS resources ineffectively.[10] Of particular concern is the IRS's penchant for correspondence exams, which constitute 77 percent of all individual exams conducted by the IRS in FY 2009.[11] This is so despite clear evidence that correspondence-based audits negatively impact the results for certain groups of taxpayers and

6 *Id.* Regarding the IRS report, I note here only that there was considerable discussion about whether to include all tax return preparers or merely "signing tax return preparers" within the scope of regulation. For reasons I detail in this report, I believe that a blanket exclusion of "nonsigning" preparers who prepare tax returns would leave a significant hole in the new regulatory regime that would be widely exploited and would thereby undercut the effectiveness of the initiative.

7 *See Running Social Programs Through the Tax System*, vol. 2, *infra.*

8 *See* Most Serious Problem: *IRS Toll-Free Telephone Service Is Declining as Taxpayer Demand for Telephone Service Is Increasing, infra.*

9 *See, e.g.*, National Taxpayer Advocate 2004 Annual Report to Congress 211-225 (Most Serious Problem: *IRS Examination Strategy*).

10 *See The IRS Examination Strategy Fails to Maximize Voluntary Compliance* and Most Serious Problems: *The IRS Correspondence Examination Program Does Not Maximize Voluntary Compliance; The IRS Does Not Know If It Is Using State and Local Data Effectively to Maximize Voluntary Compliance; The IRS Examination Function is Missing Opportunities to Maximize Voluntary Compliance at the Local Level; The IRS Lacks a Comprehensive "Income" Database That Could Help Identity Underreporting and Improve Audit Efficiency; The IRS Does Not Have A Significant Audit Program Focused on Detecting the Omission of Gross Receipts; and The IRS Has Delayed Minor Tax Form Changes That Would Promote Voluntary Compliance and Increase Audit Efficiency, infra.*

11 IRS Fiscal Year 2009 Enforcement Results, *available at* http://www.irs.gov/pub/irs-drop/fy_2009_enforcement_results.pdf (last visited Dec. 24, 2009).

certain issues.[12] We have urged the IRS to conduct a test to determine whether certain tax issues or tax populations receive more accurate audit results if the examination is conducted in a face-to-face environment or if a specific auditor is assigned to a correspondence exam (as opposed to the first available auditor each time the taxpayer calls). We hope the IRS will undertake this study in partnership with TAS and believe it would provide valuable information upon which better and more taxpayer-centric Examination policy and procedures can be formed.

Most of the issues discussed in this report – whether they involve administrative or legislative recommendations – implicate key taxpayer rights. From the taxpayer's right to an independent and impartial administrative appeal of IRS examination and collection actions,[13] to the right to certainty and finality with respect to a tax liability,[14] to the fairness and accessibility of the tax system regardless of a taxpayer's income level[15] or geographical residence,[16] to taxpayers' right to representation by a tax professional in tax matters,[17] we find the IRS all too often short-changes what it knows is the right approach for taxpayers and good tax administration because of resource-driven considerations. The IRS's response to many of our Most Serious Problems indicates that the IRS is over-stretched as a result of its expansion of duties and is unable or unwilling to commit additional resources to improving programs if they can limp along at *status quo*. As a strategy, it may get the IRS through to tomorrow, but it fails U.S. taxpayers and does not bode well for increasing the voluntary compliance in the long-term.

IRS Collection Practices May Harm Long-Term Taxpayer Compliance and Are Not Supported by Reliable Data.

The decline in the level of service on the phones, mentioned above, is exacerbated by another, more disturbing trend in IRS collection activities – namely, that the IRS establishes collection policy and procedures without credible evidence of a positive impact on voluntary (or even involuntary) compliance and without consideration of a taxpayer's facts and circumstances. Consequently, we have placed a special focus on Collection in this report, which identifies IRS lien filing policies as the second most serious problem and includes three other most serious problems, five legislative recommendations, and two research studies.

At the outset, I wish to acknowledge the importance of the IRS collection function and my confidence that, properly trained and provided appropriate guidance, it can collect the correct amount of tax revenue without causing taxpayers undue harm or impairing taxpayer rights. In fact, a robust collection function – both over the telephones and in the field – is an absolute necessity for any tax administration in that it serves as an incentive for taxpayers to comply. It is not my intention to criticize the individual performance of front-line collection employees. My concern is

12 *See* Most Serious Problem: *The IRS Correspondence Examination Program Does Not Maximize Voluntary Compliance, infra.*

13 *See* Legislative Recommendation: *Strengthen the Independence of the IRS Office of Appeals and Require at Least One Appeals Officer and One Settlement Officer in Each State*; Most Serious Problem: *Appeals' Efficiency Initiatives Have Not Improved Taxpayer Satisfaction or Confidence in Appeals, infra.*

14 *See* Legislative Recommendation: *Provide a Fixed Statute of Limitations for U.S. Virgin Islands Taxpayers, infra.*

15 *See* Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers Are Not Being Adequately Met, infra.*

16 *See* Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges, infra.*

17 *See* Most Serious Problem: *IRS Power of Attorney Procedures Often Adversely Affect the Representation Many Taxpayers Need, infra.*

with the policies and guidance under which they operate on a day-to-day basis. As described in this report, I find that many of the collection policies and practices in place today have little empirical justification even as they violate the spirit, if not the letter, of the IRS Restructuring and Reform Act of 1998 and result in unnecessary harm to taxpayers.[18]

In the course of our research about IRS collection practices and effectiveness, we learned several disturbing things:

First: The IRS does not adequately or accurately track the source of collection payments, so it has no empirical basis upon which to formulate collection policies. The IRS simply does not know with statistical accuracy what collection actions – if any – result in additional tax collection revenue for the government. The "if any" qualification here is important, because it is clear that most revenue attributed to collection comes in through automatic refund offsets or responses to the initial collection letters (the "notice stream") sent to taxpayers before a case is assigned to any collection employee.

Second: The IRS has multiple measures for what it calls "collection yield" or "enforcement revenue." These measures are not consistent and often include revenue sources that most taxpayers, economists, and policymakers would not consider to be the result of a collection activity warranting collection resources such as Automated Collection System (ACS) employees or Revenue Officers (ROs). On the one hand, the IRS publicly reports a figure for "collection yield" in the IRS Data Book that attempts to identify tax payments made as a result of some type of collection action, including liens, levies, and installment agreements.[19] On the other hand, the IRS appears to use a different measure for "enforcement revenue" for resource allocation, budget justification and congressional testimony.[20] This latter measure reports tax "revenue" actually collected over a period of time, based on the source of assessment. Thus, Examination and Appeals personnel get credit for taxes that are assessed by them, whereas Collection may get credit for any balance-due returns filed. Refund offsets are attributed to the function responsible for the underlying assessment. However, refund offsets are not the result of any one human being's intervention with the taxpayer – they are merely a computer matching program. More to the point, the enforcement revenue measure tells us very little about the effectiveness of additional investments in collection or other enforcement personnel, since it does not track what revenue resulted from which type of collection action.

Third: There is an astonishing lack of transparency as to what is included in these revenue figures and how they are computed. For example, in reviewing two consecutive Statistics of

18 For example, despite the fact that IRS levies and Notice of Federal Tax Lien filings increased by approximately 590 percent and 475 percent, respectively, between fiscal years 1999 and 2009, overall inflation-adjusted collection revenue declined by approximately 7.4 percent over the same period. *See* Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers, infra.*

19 We are not sure how Collection is able to identify these payments since our research shows that a majority of the payments in our sample were classified as "other" or "miscellaneous" or were not identified. *See* Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers. See also The IRS's Use of Notices of Federal Tax Liens*, vol. 2, *infra*.

20 The IRS tracks enforcement revenue on the Enforcement Revenue Information System, or ERIS.

Income (SOI) reports, we discovered that between 2007 and 2008, the IRS had "lost" about $32 billion in collection revenue for FYs 2005, 2006, and 2007.[21] In the 2008 SOI report, the revised figures are simply marked with an "r", which, as the footnote helpfully explains, means "revised."

We find this level (or lack) of explanation to be unacceptable. Policymakers, researchers, scholars, and the National Taxpayer Advocate rely on SOI data as a major source of information about the IRS and tax administration. In particular, it would be difficult for anyone to detect this change unless one compared the two tables side by side, as we did. This failure to highlight and explain revisions of such magnitude is inexcusable and erodes confidence in any data reporting by the IRS.

Fourth: A quick perusal of this report's most serious problems and research studies on collection shows that the IRS clearly is not looking at its collection procedures from the perspective of the taxpayer, much less from the perspective of increasing long-term, voluntary compliance. Collection's guidance is not based on data analysis that takes into account the taxpayer's perspective but instead is based on perceived "wisdom" which in many ways reflects little more than a view that what the IRS has always done must be correct. The IRS's mantra, for example, that it must file a Notice of Federal Tax Lien (NTFL) in order to protect the government's interest is meaningless if there are and likely will be no assets to which the NFTL can attach. Moreover, this justification must be balanced against the need for the taxpayer to be financially viable so as to become and remain in long-term tax compliance (and also not increase the likelihood that the taxpayer will become dependent on government benefits to meet basic living expenses). We have found, however, that IRS lien filing determinations are heavily weighted toward automatically filing liens. For reasons this report describes in detail, this approach harms taxpayers, does not produce significant revenue, and undermines broader IRS compliance goals.[22]

Fifth: Our second compliance study in Volume 2 of this report, *Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge Facing the IRS*, suggests that current IRS practices with respect to identifying taxpayers' ability to pay outstanding tax liabilities are

21 IRS, *IRS Data Books, Table 16, Delinquent Collection Activities, 2005-2008*. The IRS originally reported revenue yield for FY 2005-2007 as (in thousands, respectively): $37,113,036, $40,813,309, and $43,318,830, but corrected these figures in the 2008 IRS Data Book (in thousands, respectively) to $27,615,348, $29,172,915, and $31,952,399.

22 The question whether lien filings are required to protect the government's interest was recently presented in the context of Section 6707A penalties. In response to a congressional request, the IRS agreed this summer to hold off on taking collection action against small businesses facing the penalty to give Congress a chance to provide statutory relief. The National Taxpayer Advocate asked the IRS to refrain from imposing liens in those cases, but the IRS stated that it would continue to impose them "to protect [its] interests." For a discussion about the harsh impact of Section 6707A penalties on small business owners, see National Taxpayer Advocate 2008 Annual Report to Congress 419-22 (Legislative Recommendation: *Modify Internal Revenue Code Section 6707A to Ameliorate Unconscionable Impact*). In a letter to Secretary Geithner and Commissioner Shulman dated Dec. 22, 2009, Senator Grassley noted that "the placement of liens . . . is a significant threat" to the operations of small businesses, and he requested that the IRS "remove all liens on small businesses resulting from 6707A assessments unless there is a known risk that the taxpayer will evade payment of the penalties." According to an article in Tax Notes, an aide to Senator Grassley said in explaining the request: "Most small businesses are cooperating; they are in an audit. People who are under audit should not have to hire an attorney to fight a lien when they are already in contact with the Service." After Senator Grassley threatened to place a hold on Treasury Department nominees, the IRS agreed to hold off temporarily on filing new liens in these cases. *See* Michael Joe, *Grassley Releases Holds on Treasury Nominees After IRS Addresses Small-Business Penalties*, Tax Notes Today, 2009 TNT 245-1 (Dec. 24, 2009). While the circumstances involving Section 6707A penalties are unusual, the dialogue reflects broader concerns about IRS's automatic lien filing policies. In particular, Senator Grassley's aide said the IRS had characterized the liens as "protective filings" rather than "collection enforcement actions," a distinction that provides little solace to taxpayers whose credit scores are ruined and who lose the ability to obtain financing.

driving some taxpayers into long-term noncompliance.[23] This study found that taxpayers in the following categories all experienced high levels of downstream noncompliance:

- Taxpayers with Tax Delinquent Accounts (TDA status, in which the account has made it past the notice stream with a balance due);
- Taxpayers placed in the collection queue awaiting assignment to a revenue officer;
- Taxpayers placed in currently not collectible (CNC) hardship status (*i.e.*, the IRS determined that the taxpayer could not afford to pay the tax debt); and
- Taxpayers who had cancellation of debt income (CODI) or entered into bankruptcy.

When we probed deeper into the financial status of these taxpayers, we found that the IRS's own "allowable living expense" (ALE) standards clearly did not reflect the true financial picture of three groups of taxpayers: (1) those in CNC – hardship status (about 25 percent of those taxpayers appeared to have the ability to pay under IRS's ALE analysis); (2) those who received CODI; and (3) those who were in bankruptcy (about half of those taxpayers appeared to have the ability to pay under IRS's ALE analysis). Thus, ALE standards alone don't show the taxpayer's entire financial picture, particularly with respect to certain forms of unsecured debt such as credit cards, school loans, or medical and hospital bills. The IRS's failure to acknowledge these forms of debt appears to undermine taxpayers' efforts to become compliant. This finding has significant consequence for taxpayers in the current economic climate, as foreclosures, credit card cancellations, and bankruptcies are on the rise.

Contrast the IRS approach to Sweden's debt relief program, which operates in addition to its bankruptcy procedures. The Swedish Enforcement Agency collects both federal (including tax) and private debts (which creditors have requested the government to collect). The agency recognizes that being in debt is a self-perpetuating cycle and leads to ongoing tax noncompliance. When a taxpayer enters the debt relief program, the agency looks at all debt owed by the taxpayer – federal, local, and private creditor – and works out a payment plan over a period of years that, if adhered to, will result in forgiveness of any outstanding debt at the end of the agreement. The payment plan is based on the taxpayer's financial needs and circumstances. Most importantly, the plan does not ignore debt that is unsecured. Although the government may have priority over other creditors, it voluntarily accepts less than it is entitled to receive because it has found that the taxpayer more likely will be compliant in the future if all debt is addressed. Of course, if the taxpayer fails to complete the debt relief program, the debts stand and the government is in the same position as before the program. However, if the taxpayer completes the program, the taxpayer is well-positioned for future compliance.[24]

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23 In this study, TAS Research examined the subsequent compliance behavior of individual taxpayers who incurred failure-to-pay delinquencies in 2002 following the last recession. The study includes only taxpayers who had no prior unpaid tax liabilities at the time they acquired their delinquencies. The study tracked the compliance history of this cohort of taxpayers from the time their delinquencies began in 2002 through the first quarter of 2009.

24 "Persons in very deep indebtedness may be forced to live at the level of subsistence for the rest of his/her life if he/she does not get a debt relief." *The Swedish Enforcement Authority*, May 2009 (presentation to the National Taxpayer Advocate).

This approach makes so much more sense than the current IRS policy of ignoring unsecured debt (including state tax debt) in establishing payment plans and evaluating offers in compromise. Any taxpayer with these debts will tell you that these creditors don't go away – the state tax agency doesn't stop garnishing a paycheck just because the IRS has priority, and a credit card collection company doesn't stop calling daily just because you are in an IRS payment plan. Instead, taxpayers are placed in the intolerable position of agreeing to pay the IRS more than they can actually afford (given their other debts) and then defaulting on the IRS payment arrangements when they channel payments to unsecured creditors in order to get some peace. Thus, the IRS itself fosters noncompliance by its failure to take a holistic approach to the taxpayer's debt situation.

Fundamental Tax Simplification Is Desperately Needed.

In several prior reports, I have designated the complexity of the tax code as the most serious problem facing taxpayers and the IRS alike. The need for tax simplification is not highlighted as a separate discussion in this year's report to avoid repetition, but the omission of a detailed discussion in no way suggests the lessening of its importance.

As I detailed in last year's report, TAS analysis of IRS data shows that U.S. taxpayers and businesses spend about 7.6 billion hours a year complying with the filing requirements of the Internal Revenue Code. It would require 3.8 million workers to consume 7.6 billion hours, effectively making the "tax industry" one of the largest industries in the United States.[25] U.S. taxpayers deserve a simpler and less burdensome tax system.

Sooner or later, tax reform will come. And while the Office of the Taxpayer Advocate generally refrains from becoming involved in tax policy discussions, we have sought to make a contribution by presenting a taxpayer perspective on tax simplification and by addressing the tax administration implications of certain aspects of tax reform.

In 2004, we presented recommendations to streamline the bewildering array of education and retirement savings incentives in the tax code.[26] In 2005, I made a presentation to the President's Advisory Panel on Federal Tax Reform and suggested that emphasis be given to six taxpayer-centric core principles.[27] We also presented a proposal to reform the rules governing married persons filing joint returns and the taxation of community property.[28] Last year, we recommended simplifying the

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25 For details and additional data, see National Taxpayer Advocate 2008 Annual Report to Congress 3-14 (Most Serious Problem: *The Complexity of the Tax Code*). *See also* Nina E. Olson, *We Still Need a Simpler Tax Code*, Wall Street Journal, Apr. 10, 2009, at A13).

26 *See* National Taxpayer Advocate 2004 Annual Report to Congress 403-422 (Legislative Recommendation: *Simplification of Provisions to Encourage Education*); National Taxpayer Advocate 2004 Annual Report to Congress 423-432 (Legislative Recommendation: *Simplification of Provisions to Encourage Retirement Savings*).

27 *See* Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Nina E. Olson, National Taxpayer Advocate), *at* http://www.taxreformpanel.gov/meetings/meeting-03032005.shtml. For more detail, see National Taxpayer Advocate 2005 Annual Report to Congress 375-380 (Legislative Recommendation: *A Taxpayer-Centric Approach to Tax Reform*).

28 National Taxpayer Advocate 2005 Annual Report to Congress 407-432 (Legislative Recommendation: *Another Marriage Penalty: Taxing the Wrong Spouse*).

"family status" provisions in the tax code,[29] reducing the use of "tax sunsets,"[30] reducing the use of income "phase-out" provisions,[31] and simplifying worker classification determinations.[32] Last year's report also contained a comprehensive set of recommendations to simplify the penalty provisions in the tax code.[33] This year, we present two studies in volume 2 that should assist in developing tax reform – one on principles for running social benefit programs through the tax code[34] and one discussing administrative considerations that should be kept in mind if the U.S. decides to adopt a VAT-like tax.[35] Our office does not take a position on whether running social programs through the Code or adopting a VAT is good policy, but we do believe that policymakers should be aware of these concerns if these policies are adopted.

We will continue to do our part to encourage support for fundamental tax simplification and to offer a taxpayer perspective on what tax simplification should look like.

Conclusion

As I see it, the IRS is subject to three diverging forces – increased responsibility for non-core tax administration duties, increasing demand for taxpayer service (including telephone assistance) and declining resources for that demand, and collection policies that mask a laissez faire attitude to taxpayer harm under the guise of "efficiency." The taxpayer is wedged in the middle of these forces, being pulled in all directions, but never the right one. How the IRS weathers this storm depends on its willingness to candidly reassess its taxpayer service and enforcement strategies and commit to necessary changes, as well as on congressional oversight to ensure that this happens.

As always, I look forward to working with the IRS and with Members of Congress to strengthen the administration of our tax laws while ensuring that taxpayer rights are protected and taxpayer burden is minimized I hope this report contributes toward that end.

Respectfully Submitted,

Nina E. Olson
National Taxpayer Advocate
31 December 2009

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29 National Taxpayer Advocate 2008 Annual Report to Congress 363-369 (Legislative Recommendation: *Simplify the Family Status Provisions*). *See also* National Taxpayer Advocate 2005 Annual Report to Congress 397-406 (Legislative Recommendation: *Tax Reform for Families: A Common Sense Approach*).

30 National Taxpayer Advocate 2008 Annual Report to Congress 397-409 (Legislative Recommendation: *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*).

31 National Taxpayer Advocate 2008 Annual Report to Congress 410-413 (Legislative Recommendation: *Eliminate (or Simplify) Phase-outs*.

32 *Id*. at 375-390 (Legislative Recommendation: *Worker Classification*).

33 *Id*. at 414-418 (Legislative Recommendation: *Reforming the Penalty Regime*), and vol. 2 (Report: *A Framework for Reforming the Penalty Regime*).

34 *See Running Social Programs Through the Tax System*, vol. 2, *infra*.

35 *See An Analysis of Tax Administration Issues Raised by a Consumption Tax, Such as a National Sales Tax or Value Added Tax*, vol. 2, *infra*.

The Most Serious Problems Encountered by Taxpayers

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(III) requires the National Taxpayer Advocate to describe at least 20 of the most serious problems encountered by taxpayers. This year's report begins by identifying the five most serious problems and then divides the remaining problems into four categories – taxpayer service issues, examination issues, collection issues, and general tax administration issues. The report also contains status updates on two issues the National Taxpayer Advocate identified as problems in prior reports – tax-related identity theft and automated levies imposed on Social Security recipients under the Federal Payment Levy Program.

Each of the most serious problems includes the National Taxpayer Advocate's description of the problem, the IRS's response, and the National Taxpayer Advocate's final comments and recommendations. This format provides a clear picture of which steps have been taken to address the most serious problems and which additional steps the National Taxpayer Advocate believes are required.

The issues described in the report are as follows:

1. IRS Toll-Free Telephone Service Is Declining as Taxpayer Demand for Telephone Service Is Increasing

Problem

Over the last three years, taxpayers have found it increasingly difficult to reach an IRS employee by telephone. During the 2007 filing season, the IRS attained a Customer Service Representative Level of Service (CSR LOS) of 83 percent on its toll-free lines. (The CSR LOS measures the percentage of callers seeking to speak with an IRS employee that gets through to one.) During the 2008 filing season, the CSR LOS declined to 77 percent. During the 2009 filing season, the CSR LOS dropped further to 64 percent with a 519-second average speed of answer (ASA), which means that the average caller sat on hold for nearly nine minutes. These declining numbers indicate that, at least with respect to its toll-free telephone lines, the IRS is not achieving its goal of improving service to facilitate voluntary compliance.

In response to the declining levels of phone service, the IRS has set goals of 71.2 percent for CSR LOS and 698 seconds for ASA in fiscal year 2010. In other words, the IRS has set its priorities so that nearly three out of every ten callers seeking to reach an IRS telephone assistor will not get through, and those who do receive assistance will wait on hold for an average of nearly 12 minutes.

Analysis

Successful taxpayer service means providing a number of ways to reach the IRS, one of which is the toll-free lines. However, increased volume and inadequate staffing have resulted in a decline in the level of service on the toll-free lines. Much of the increased demand is attributable to one-time events (*e.g.*, late-year tax law changes, confusion about Economic Stimulus Payments, and national disasters). Regardless of the cause, the inability of the IRS to adequately answer taxpayer phone calls leads to significant downstream consequences since the same employees who answer the CSR toll-free lines also process taxpayer letters to the IRS, resulting in significant over-age correspondence. Taxpayers whose correspondence goes unanswered call the IRS, and when they cannot get through, they either write to the IRS again or just give up. This downward spiral creates re-work for the IRS and discourages taxpayers from contacting the IRS, which in turn can undermine tax compliance.

Recommendations

The National Taxpayer Advocate recommends that the IRS staff its toll-free lines at a level sufficient to achieve a CSR LOS of 85 percent and an ASA of 300 seconds, and further recommends that the IRS create a dedicated phone unit specially trained to deal with tax issues relating to national disasters and late-year or one-time tax law changes.

2. One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers

Problem

The notice of federal tax lien (NFTL) can be an effective tool in tax collection when used properly. It gives the IRS a priority interest in the taxpayer's property, such as a home or a car, and may enable the IRS to collect all or a portion of the tax debt if the taxpayer sells or refinances the property. If improperly applied, however, tax liens can needlessly harm taxpayers and undermine long-term tax collection. The filing of a tax lien can significantly affect the taxpayer's credit and ability to obtain financing, find or retain a job, secure affordable housing or insurance, and ultimately pay the tax bill. For these reasons, the decision to impose a tax lien should be made on a case-by-case basis. Yet, the IRS files many liens systemically, pursuant to "business rules" that require automatic lien filing or a lack of substantive human review.

Analysis

The National Taxpayer Advocate has identified a number of concerns with the IRS's NFTL policy, including lack of managerial review prior to most NFTL filings, lack of verification of assets prior to filing an NFTL, unnecessary harm to taxpayers whose accounts are reported currently not collectible (CNC), and failure by the IRS to fully utilize its statutory authority to withdraw NFTLs.

TAS conducted a high-level collection research project that, in part, attempted to assess whether the IRS is filing liens effectively to collect revenue and achieve long-term compliance. Over the past decade, filings have increased by nearly 475 percent, yet overall inflation-adjusted Collection revenue has declined by approximately 7.4 percent. TAS's analysis reveals that the IRS does not accurately track the source of tax payments received on past-due accounts. In most instances where the payment source (via a Designated Payment Code or DPC) is specified, more than 95 percent of all payments and more than 80 percent of all revenue collected did not result from the lien filings and would have been collected anyway. The largest share of revenue was attributable simply to the IRS withholding tax refunds due in future years to satisfy these past-due debts.

A further TAS analysis of taxpayers in CNC (hardship) status shows that only about five percent of all payment transactions and approximately 20 percent of the total dollars collected from these taxpayers are attributable to NFTLs. These results suggest that the IRS's use of liens may not be furthering revenue collection, and, equally significant, that the IRS is utilizing lien-filing policies that have little empirical support and that harm taxpayers.

Recommendations

The National Taxpayer Advocate recommends that the IRS reform its lien-filing practices to enhance their efficacy, increase long-term voluntary compliance, and minimize taxpayer harm by (1) immediately implementing a quality review of DPCs; (2) adopting two long-term effectiveness measures to ensure that employees file appropriate and productive NFTLs; (3) abandoning the policy of automatic NFTL filing on CNC hardship accounts with an unpaid balance of $5,000 or more; (4) implementing the provisions of RRA 98 § 3421 by basing lien filing determinations by all IRS contact employees on a thorough review of all taxpayer's circumstances (including the existence and value of assets, the taxpayer's financial information, and the ramifications of the lien on the taxpayer's credit rating); (5) requiring managerial approval for NFTL filings in all cases where the taxpayer has no assets, regardless of the employee's grade level; (6) immediately issuing interim guidance to allow, upon the request of a taxpayer, the withdrawal of an NFTL where the statutory withdrawal criteria are satisfied, even if the underlying lien has been released; and (7) conducting annual training for IRS Collection employees and managers in exercising judgment and discretion before and after NFTL filing, including the TAS training video, *Taxpayer Rights: Collection Case Studies*.

3. The IRS Lacks a Servicewide Return Preparer Strategy

Problem

Return preparers play a critical role in the tax system. About 58 percent of individual taxpayers and 80 percent of small business taxpayers hire preparers to complete their returns for them. Return preparers therefore are largely responsible for the accuracy of most returns filed with the IRS, help to protect taxpayer rights, and play a significant role in ensuring tax compliance. Yet anyone can prepare a tax return for a fee – with no training, no licensing, and no oversight required.

Lack of preparer knowledge leads to significant errors in return preparation. The lack of oversight also enables unscrupulous preparers to operate with minimal risk of detection.

Analysis

The Government Accountability Office (GAO), the Treasury Inspector General for Tax Administration (TIGTA), and other organizations have conducted undercover visits to tax preparers in recent years and found extremely high rates of error and misconduct. Using two fairly straightforward tax patterns, GAO found that preparers computed the wrong tax amount in 17 of 19 visits, with five returns showing unwarranted excess refunds of nearly $2,000 and two returns requiring the GAO "taxpayer" to pay over $1,500 more in tax than he actually owed. In ten cases, the preparers failed to report side income, and in several cases, they explicitly advised the GAO "taxpayer" that reporting the side income was unnecessary because the IRS would have no way to discover it. The results of the TIGTA study are equally concerning.

To protect taxpayers and improve return accuracy, the National Taxpayer Advocate has repeatedly recommended that the IRS develop a strategy to improve preparer competence, visibility, and accountability.

Recommendations

The National Taxpayer Advocate recommends that the IRS develop a comprehensive return preparer strategy that includes: (1) a requirement that all persons who prepare tax returns and interact with taxpayers obtain and use a unique identifying number (known as a PTIN); (2) a requirement that all unenrolled preparers pass an examination that tests basic return preparation knowledge and thereafter complete periodic continuing education courses; (3) a public awareness campaign to inform taxpayers of preparer requirements; (4) creation of a publicly available database listing all certified preparers; (5) a large-scale program of IRS preparer visits; and (6) due diligence requirements covering areas of significant noncompliance.

4. Appeals' Efficiency Initiatives Have Not Improved Taxpayer Satisfaction or Confidence in Appeals

Problem

The Office of Appeals (Appeals) provides a vital service to taxpayers. However, the overall customer satisfaction rate for Appeals is low (65 percent), and satisfaction with campus Appeals operations was lower than for its field offices in FYs 2007 and 2008. Among unrepresented taxpayers, the customer satisfaction rate was only 53 percent in FY 2008. Moreover, Appeals has not conducted a taxpayer-based assessment to consider the taxpayers' conference needs or preferences. The National Taxpayer Advocate is concerned that Appeals' efficiency initiatives undermine its effectiveness and diminish its unique ability to listen to taxpayers and settle their cases.

Analysis

From FY 2006 to FY 2008, Appeals prioritized improving its processes and cycle time over improving taxpayer service. Yet efficiency gains have not improved taxpayer satisfaction. Rather, Appeals' customer satisfaction surveys indicate that poor communication, untimely service, and deteriorating relationships with taxpayers are its greatest problems. Appeals fails to inform taxpayers of representation options, require employees to educate unrepresented taxpayers about the Appeals process, or notify taxpayers of delays and give them a reasonable time estimate for their appeals. Further, Appeals fails to analyze data and report on whether taxpayers are receiving requested hearings. Campus specialization enabled Appeals to achieve reductions in cycle time but it created other problems, most notably the loss of local knowledge. The National Taxpayer Advocate believes taxpayers should be entitled to have hearings with local appeals or settlement officers when local economic conditions or issues are involved, and urges Appeals to weigh taxpayer preferences carefully in making local hearings available.

Recommendations

The National Taxpayer Advocate recommends that the IRS allocate resources and revise procedures to require that Appeals employees contact the taxpayer routinely while his or her appeal is pending; revise all uniform acknowledgment letters to include information on alternative forms of assistance, such as Low Income Taxpayer Clinics and TAS; revamp databases and quality measures to track and compile data in all categories; conduct a taxpayer-focused survey to help guide resource allocation decisions between campus and field Appeals; increase local office staffing so that at least one Appeals officer and one settlement officer sit in each office; implement a pilot to hold closed-circuit videoconferencing between remote areas and Appeals offices; and require management to conduct non-evaluative early intervention and 100-day case reviews.

5. The IRS Lacks a Servicewide E-Services Strategy

Problem

The IRS faces many challenges in meeting the technological preferences of taxpayers and practitioners in their interactions with the agency. While the IRS has developed a significant number of online tools, it appears to have no overarching strategy for developing, implementing, and improving its electronic services. The IRS should regularly monitor taxpayer and practitioner preferences for service delivery and build upon the findings of the Taxpayer Assistance Blueprint (TAB) Strategic Plan and the Advancing e-File Study to develop a servicewide electronic services strategy. Such a strategy should address online account management, a direct filing option, 2-D barcode technology, and faster refund turnaround times.

Analysis

The TAB envisioned an "interactive and fully integrated, online tax administration agency" and recommended that the IRS develop service delivery channels similar to those offered by many large financial institutions. The IRS faces several obstacles in developing a new e-services application, including e-authentication, portal technology, and limited resources. However, various studies and survey data substantiate the need for a comprehensive e-services strategy. The IRS should study the experiences of other governmental and private entities that have moved their services online to learn about the obstacles, usage, and impact on "customer" behavior they encountered.

We are pleased that the IRS has committed to carry out or consider the following initiatives: (1) create a cross-functional e-services governance body; (2) conduct a study similar to the TAB for both Small Business/Self-Employed (SB/SE) taxpayers and exempt organizations; (3) implement 2-D barcoding or similar technology to process paper returns; and (4) develop servicewide e-authentication and portal strategies.

Recommendations

The National Taxpayer Advocate recommends that the IRS improve its filing template and develop a direct filing portal; reduce the refund turnaround time to the shortest length possible with publication of actual refund delivery times; include a Revenue Protection Indicator in the acknowledgement file to indicate potential compliance issues; create a Treasury stored value card and immediately publicize that taxpayers may use their existing stored value cards to receive refunds during the 2010 filing season; and develop an online account management program to enable taxpayers to monitor their tax accounts and resolve account issues securely over the Internet.

Taxpayer Service Issues

6. Beyond EITC: The Needs of Low Income Taxpayers Are Not Being Adequately Met

Problem

Individuals with incomes below the poverty level make up 12.5 percent of the United States population, or 37 million people. These taxpayers often face issues that impact their interaction with the IRS and thus require customized service solutions, particularly in the audit and collection context. The IRS lacks a comprehensive low income taxpayer strategy, instead relying on a piecemeal approach to serving this taxpayer population that does not incorporate into enforcement activities and training what it has learned through Taxpayer Assistance Blueprint and Earned Income Tax Credit (EITC) research. Additionally, the IRS often fails to involve TAS and the Low Income Taxpayer Clinics in projects where it does not consider the *specific* impact on low income taxpayers, resulting in the need to rework projects when the impact becomes obvious. A "one size fits all" approach does not meet the needs of the low income taxpayer population.

Analysis

Low income taxpayers face barriers to service that differ from other taxpayer populations. There are costs to being poor. Living in some poor neighborhoods restricts residents' access to banks, since many such neighborhoods have no bank branches, offering only expensive check-cashing services, loan sharks, or subprime lenders. The poor may not have access to remedies that require money. Low income taxpayers tend to be more transitory than the general population, with 27.5 percent of those below the poverty level moving in 2007 while only 15 percent of the general population moved during the same time.

These issues and others present a challenge for the IRS as it develops products, programs, notices, and forms that impact this population. Despite the specialized needs of the low income population, the IRS lacks a strategic, cross-functional approach toward meeting the needs of low income taxpayers. While its work in certain areas, such as the EITC, is commendable, the IRS fails to put forth a similar effort in other areas where low income taxpayers need assistance, particularly with respect to post-filing activities such as audit and collection. Low income taxpayers encounter tax issues beyond just the EITC, and the IRS has not addressed many of these areas sufficiently.

Recommendations

The National Taxpayer Advocate recommends that the IRS develop a more comprehensive strategy to assist low income taxpayers in complying with their tax obligations and availing themselves of taxpayer rights by (1) partnering with TAS to complete a post-filing needs assessment of low income taxpayers, which would encompass issues other than EITC; (2) partnering with TAS to create training videos on working with taxpayers with special needs; (3) creating business measures that assess the impact of IRS programs on low income taxpayers; and (4) testing programs and products that impact low income taxpayers in a cognitive research lab.

7. U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges

Problem

U.S. taxpayers living or conducting business abroad face serious challenges in understanding and meeting their federal tax obligations. These taxpayers may be confused by the complexity of international tax law or overwhelmed by the prospect of figuring out what the IRS requires. Many taxpayers also remain unclear about mandatory self-reporting on foreign financial accounts, which is required even if no tax is due. The IRS does not provide adequate service or sufficiently consider these taxpayers' needs and preferences. This lack of service creates an unfair burden on these taxpayers to independently meet their obligations, and places them at risk of additional penalties if they fail to do so.

Analysis

It is estimated that more than seven million American citizens reside abroad. Although U.S. citizens are required to file U.S. income tax returns regardless of their residency status, IRS data show that only 462,340 taxpayers (or 6.6 percent) filed returns from a foreign address in tax year 2007. At the same time, 239,287 small businesses conducting business abroad (or 97.3 percent of all known exporters) must cope with additional tax complexities. Considering their geographical isolation from the IRS and U.S. private sector tax services, these taxpayers are at a clear disadvantage compared to their counterparts located in the United States. U.S. citizens and small businesses living or operating abroad require the same level of service and information about their tax obligations as all U.S. taxpayers.

Recommendations

The National Taxpayer Advocate recommends that the IRS develop a comprehensive strategy to assist U.S. taxpayers located or conducting business abroad that includes (1) identifying U.S. taxpayers located or conducting business abroad and assessing their filing compliance rate; (2) creating an outreach campaign, including a dedicated web page for small businesses, specifically targeting problems facing this taxpayer population based on a survey of needs and preferences of U.S. taxpayers abroad; (3) devoting more tax attaché posts to taxpayer service, including reinstatement of in-person taxpayer service to U.S. taxpayers residing in Mexico; (4) opening case resolution rooms at tax attaché posts and during tax venues abroad; and (5) implementing a pilot pre-filing agreement program for small businesses with reduced fees and reduced filing fees for the advance pricing agreement program for businesses with assets of $10 million or less.

Examination Issues

8. The IRS Correspondence Examination Program Does Not Maximize Voluntary Compliance

Problem

In an effort to maintain "audit coverage" (*i.e.*, the percentage of returns examined by the IRS), the IRS significantly expanded its use of correspondence examinations – from 54 percent of all examinations in FY 2000 to 72 percent of all examinations in FY 2008 – without first doing the research necessary to know if these audits actually increase or decrease voluntary compliance by the taxpayers now subject to them. An increase in audit coverage at the expense of quality may actually reduce voluntary compliance if taxpayers conclude that an examination will not detect tax cheating, or that the audit process is arbitrary or unfair.

Analysis

For some taxpayers or issues, correspondence examinations are more likely to reach the wrong result because of communication difficulties and the limited scope of these audits. For example, it is difficult for the IRS to detect unreported income when conducting examinations by correspondence. Examinations of issues that require a significant amount of documentation or explanation, such as employee business expense deductions, also present challenges. Examinations of low income taxpayers involving complicated issues such as the Earned Income Tax Credit (EITC) may be particularly problematic.

A study of cases in which a correspondence examiner had denied the EITC and the taxpayer subsequently requested audit reconsideration found that communication and documentation difficulties in the original examination prompted 42 percent and 45 percent, respectively, of the requests for audit reconsideration. Forty-three percent ultimately received the EITC, and the amount received was, on average, 96 percent of what the taxpayer claimed on the original return. In essence, the likelihood that the IRS had obtained the right result the first time was not much better than a coin toss would produce. The IRS is working with TAS to address certain documentation challenges. It also has tentative plans to study the results of correspondence and field audits of similar issues, which could be informative. However, before completing this research, the IRS plans to increase its use of correspondence examinations for complex issues.

Recommendations

The National Taxpayer Advocate recommends the IRS research the impact of different types of examinations on voluntary compliance; commence the research it is planning in this area; not expand the use of correspondence examinations to more complex issues before completing research to know the effect of such examinations; and continue working with TAS to address the documentation issues presented by correspondence examinations.

9. The IRS Examination Function Is Missing Opportunities to Maximize Voluntary Compliance at the Local Level

Problem

Local examination projects (called "compliance initiative projects" or CIPs) that rely on local data sources or utilize local partners, can often uncover unreported business income – including income from the cash economy, which represents the largest portion of the tax gap – more effectively than national return selection techniques. Because local small businesses communicate with each other, this approach can also have a greater indirect effect on voluntary compliance than seemingly random examinations. The IRS could leverage the positive effects of local CIPs by using a multi-functional approach, for example, by doing outreach and education in the same community. However, it does little to encourage the development of local CIPs and has no national measures that can reliably distinguish good CIPs from bad ones. As a result, the IRS is missing opportunities to maximize voluntary compliance at the local level.

Analysis

The IRS does not specifically allocate resources to pursue CIPs, which are "discretionary" work, but has urged the area offices to develop CIPs by including a statement to that effect in the Small Business/Self-Employed division Examination Program Letter. However, the letter does not encourage Examination employees to work with other functions and local partners, using local data sources. Nor does it specifically encourage the use of CIPs to address noncompliance by cash economy businesses. During FY 2008 and FY 2009, the IRS initiated 55 and 72 CIPs respectively. However, of the 72 CIPs in FY 2009, only one involved another IRS function, only seven utilized state or local data, and we could not determine how many of these focused on cash economy businesses. The IRS believes that current examination measures such as dollars per hour, average dollars per return, no change rates, and related return pick-up percentage are sufficient, and does not believe that additional measures are necessary. However, the IRS's goal is to increase voluntary compliance, which these measures do not capture. For example, some CIPs that generate small assessments may have large effects on voluntary compliance. Thus, the IRS statement that better measures are unnecessary is akin to taking the position that our goal is to win the World Series, but we do not believe it is necessary to keep score.

Recommendations

The National Taxpayer Advocate recommends the IRS work with its research function to develop better measures for the CIP program or at least better ways to analyze and evaluate CIP results and require each area examination function to do at least some CIP work with other IRS functions and local partners, using local data sources to address noncompliance by local cash economy businesses.

10. The IRS Does Not Know if It Is Using State and Local Data Effectively to Maximize Voluntary Compliance

Problem

The IRS's use of state and local data – such as sales tax data – to detect unreported income could prompt taxpayers operating in the cash economy to report more of their income that is not subject to federal information reporting. Thus, selecting returns for examination using state and local data could be a particularly effective way to increase voluntary compliance. However, the IRS has no measures to show whether returns selected for examination using one type of data are better at promoting voluntary compliance than another. As a result, it may be difficult for the IRS to justify selecting many returns for examination based on the state and local data.

Analysis

The IRS receives state income, sales (*e.g.*, from sales tax returns), and withholding information as part of its State Reverse File Matching Initiative (SRFMI). It receives state and local audit reports as part of its State Audit Report Program (SARP). It also exchanges employment tax audit reports, audit plans, participates in side-by-side examinations with state and local government agencies, and collaborates on outreach and educational opportunities as part of its Questionable Employment Tax Practices (QETP) Program.

Returns selected using SRFMI or SARP data are generally less likely to result in "no changes" (*i.e.*, lower no-change rates) and more likely to yield higher dollars per hour than comparable returns selected by other methods. However, returns selected using QETP data generally had higher no-change rates and lower dollars per hour. The IRS acknowledges that traditional metrics are not good measures for the QETP program because they do not capture the impact of the program on future compliance.

The IRS is working to develop measurable objectives for the SRFMI program. It also plans to undertake research that may generate plausible estimates of the impact of examinations on compliance. According to the IRS, however, it "may not be possible to distinguish between examinations based on such things as the types of state and local data used."

Recommendations

The National Taxpayer Advocate recommends the IRS design research to yield actionable information about the impact of examinations on voluntary compliance (*e.g.*, whether using state and local data increases the impact of examinations on voluntary compliance) and develop practical measures (or analysis) for use in evaluating the overall success of audits using state and local data, as discussed above in connection with CIPs.

11. The IRS Lacks a Comprehensive "Income" Database that Could Help Identify Underreporting and Improve Audit Efficiency

Problem

A comprehensive database containing all data relating to gross receipts – such as credit card information reports (when available), sales tax data, and currency transaction reports – could help the IRS improve its system of selecting returns for examination and overall audit efficiency. Because no such database exists, the IRS has room to improve its ability to detect unreported income – the largest component of the tax gap.

Analysis

The IRS generally agrees "multiple forms of gross receipt information need to be electronically accessible to properly address underreporting and non-reporting during selection, classification, matching, and examination processes." Some receipt-related data is available on two systems: the Compliance Data Environment (CDE) and the Integrated Production Model (IPM). For technical reasons, however, CDE is better for case building and IPM is better for return selection. Accordingly, the IRS plans to add certain data to IPM, and expand its functionality and customer base as funding and resources allow. If implemented, these plans would permit the IRS to expand the use of IPM beyond case selection to case building.

Recommendations

The National Taxpayer Advocate recommends the IRS add more receipt- and asset-related data to IPM, such as State Audit Report Program data, cash payments (*i.e.*, Bank Secrecy Act Program data), taxpayer bank account data, and credit card information reporting data (when available) and create or modify applications to access IPM data so the IRS can use the data for both automated income tax return selection and case building.

12. The IRS Does Not Have a Significant Audit Program Focused on Detecting the Omission of Gross Receipts

Problem

Specialized examiners who focus on detecting unreported income conduct an insignificant number of examinations. As a result, there is room for improving the IRS's ability to detect unreported income – the largest component of the tax gap.

Analysis

The IRS expects all examiners to detect unreported income. Recognizing the benefits of specialization, however, it has two specialized programs for detecting unreported income: the Special Enforcement Program (SEP) and the Offshore Compliance Initiative Program, which is a part of the Abusive Transaction Program. Because the SEP group focuses on intentional underreporting of legal and illegal income (*i.e.*, fraud) and the Offshore group focuses on taxpayers with a connection to offshore transactions, however, these groups will not address income unreported by taxpayers whose intent is difficult to prove and who do not have an offshore connection.

Moreover, these specialized groups closed fewer than 9,525 examinations in FY 2008 – only 0.62 percent of the total – and not all of these focused on unreported income. The draft FY 2010 Exam Plan allows for an increase in SEP "non-case time" of 16.25 staff years. The IRS is also expanding its offshore groups. However, when we consider that unreported income is the single largest component of the tax gap, more than 80 percent of all individual examinations are conducted by correspondence (a process ill-suited for detecting unreported income), and less than one percent are conducted by specialized groups, the proposed increase may not be adequate. Moreover, the SB/SE operating division is losing the examiners in its Offshore group, as the IRS is transferring them to the Large and Mid-Size Business division. This reorganization could potentially reduce the resources devoted to detecting unreported income by domestic businesses operating in the cash economy.

Recommendations

The National Taxpayer Advocate recommends the IRS create a specialized group (or expand the size and scope of existing groups) to focus on detecting unreported gross receipts by taxpayers whose income is not subject to information reporting without regard to the offshore or intentional aspects of any underreporting. She also recommends that the IRS provide these specialized groups access to information that would be available in the "income" database proposed above.

13. The IRS Has Delayed Minor Tax Form Changes that Would Promote Voluntary Compliance and Increase Audit Efficiency

Problem

The IRS has declined to make two simple changes to tax forms that could help maximize voluntary compliance. By adding a line to Schedule C to break out income not reported on Forms 1099 (*e.g.*, cash) the IRS would remind taxpayers that cash receipts are actually taxable. This one line could potentially improve voluntary compliance, as well as the IRS's ability to identify those who are not properly reporting cash sales.

Adding two checkboxes to business tax returns to highlight information reporting requirements could have a similarly positive effect. Taxpayers report more than 95 percent of all income subject to information reporting but less than 50 percent of the income that is not. Thus, if it reduced inadvertent failures by payors who are required to file information returns, these checkboxes could increase compliance by prompting payees to report amounts shown on these returns.

Analysis

In her 2005 Annual Report to Congress, the National Taxpayer Advocate recommended these form changes. The IRS agrees that these changes may have a positive impact on compliance, but has not agreed to make them. On one hand, it has suggested that an Information Reporting and Document Matching team, which includes a TAS representative, is reviewing and revising the Schedule C and business returns as part of its plan to implement the new credit card receipt and basis reporting rules. On the other hand, it has also stated that it needs to weigh the benefits and burdens of the proposed changes before implementing them, and has not yet begun to do so in the four years since the National Taxpayer Advocate first made these recommendations.

Recommendations

The National Taxpayer Advocate recommends the IRS set a date by which it will complete any analysis of the benefits and burdens of the simple form changes (described above) that it deems necessary and, unless the IRS shows the burdens of these form changes outweigh the benefits, set a date by which it will implement them.

Collection Issues

14. The Steady Decline of the IRS Offer in Compromise Program Is Leading to Lost Opportunities for Taxpayers and the IRS Alike

Problem

The underutilization of offers in compromise (OICs) directly conflicts with both the IRS's policy statement for the OIC program and Congress's intent for its use, as evidenced by the 72 percent decline in the number of offers that the IRS has accepted from FY 2001 to FY 2009. This decline is particularly troubling given that the IRS maintains a "currently not collectible" inventory of nearly $61 billion (representing over 2.8 million taxpayers). While the National Taxpayer Advocate applauds recent IRS efforts to improve the OIC program, she remains concerned that these steps will not reform the OIC program sufficiently to convince taxpayers that the offer is a viable alternative in the IRS's collection strategy, rather than a separate program designed for only a select few.

Analysis

An OIC is an agreement between a taxpayer and the government wherein, after reviewing the taxpayer's specific circumstances, the government accepts payment of less than the full amount owed in exchange for the taxpayer's promise to abide by the tax laws for at least five years. Today, a taxpayer must complete more than 100 steps in a 44-page package to apply for an OIC. These forms and instructions create confusion for most taxpayers and erode opportunities for the IRS to receive acceptable OICs. Once the IRS receives an offer, it generally is sent to a centralized function for processing and evaluation. Although intended to increase processing efficiency, centralization of the IRS's offer program has created a "bottleneck" for processing a growing number of seemingly acceptable cases with a limited number of employees. Additionally, the IRS does not maintain any meaningful local presence for its OIC investigations. Finally, the imposition of a user fee on November 1, 2003, and the down payment requirement imposed by the Tax Increase and Prevention Reconciliation Act of 2005 have further discouraged taxpayers from submitting OICs.

Recommendation

For the IRS to restore credibility and viability to its OIC program, the National Taxpayer Advocate recommends that the IRS conform its OIC procedures to more closely follow Policy Statement P-5-100; evaluate OICs in light of the IRS collectibility curve that shows little or no revenue from taxpayers whose tax liability has aged more than three years; place the ability to work and accept OICs back in the revenue officer's collection toolkit; revise Form 656, *Offer in Compromise*, to eliminate taxpayer substantiation and large amounts of documentation upon submission; and revise procedures so that OIC personnel discuss the taxpayer's financial information and the terms of the offer with the taxpayer at the outset of the offer negotiation.

15. IRS Policies and Procedures for Collection Statute Expiration Dates Adversely Affect Taxpayers

Problem

The IRS continues to miscalculate collection statute expiration dates (CSEDs) and has not addressed lengthy CSEDs on certain taxpayer accounts. As of September 24, 2009, more than 4,600 taxpayers have accounts with CSED extensions that would violate IRS policy if entered into today. Moreover, a review of collection-related cases in TAS inventory found that over 60 percent contained one or more miscalculated CSEDs.

Analysis

Generally, the IRS must collect a taxpayer's liability within ten years after it is assessed. By statute, various conditions and agreements suspend or extend the period for collection. TAS must submit numerous requests to the IRS operating divisions and functions to resolve CSED problems. We recently reviewed 50 collection-related cases in TAS inventory to determine the extent of incorrect CSED calculations. Thirty-three of the 50 cases involved multiple issues that could affect the CSED, and 31 of them contained one or more miscalculated CSEDs. When it miscalculates a CSED, the IRS may take unnecessary action and force taxpayers to overpay or underpay their tax liabilities. Further, the National Taxpayer Advocate is concerned that the IRS continues to neglect a group of taxpayers with CSEDs that were unreasonably extended in the past. Before the IRS changed its policy regarding CSED extensions pursuant to the IRS Restructuring and Reform Act of 1998, it was common for IRS Collection personnel to extend collection statutes for periods as long as ten, 20, 30, 40, or even 50 years in conjunction with an IRS installment agreement. Moreover, the IRS's limited training involving CSED issues and employees who lack skills to properly calculate CSEDs cause erroneous CSEDs, while a lack of centralization for CSED issues prolongs case resolution.

Recommendation

The National Taxpayer Advocate recommends that the IRS should permanently resolve excessively long CSEDs by writing off any balance due on accounts with CSEDs greater than the original CSED plus five years (absent other extensions allowed for by law); provide comprehensive training and continuing education to all employees who work with CSEDs so they can identify problematic CSED cases to refer to a centralized CSED unit; develop systems that can identify CSED problems so they can be resolved quickly; and establish a centralized unit to work difficult CSED cases.

16. The IRS's Approach toward Taxpayers During and After Bankruptcy May Impair Their "Fresh Start" and Future Tax Compliance

Problem

The number of bankruptcy filings in the United States has increased by 31 percent from calendar year 2007 to 2008. Accordingly, the effect of bankruptcy law on tax debts is often confusing to taxpayers and their representatives. Even if the tax is dischargeable, the IRS can collect the discharged tax by enforcing its lien interest on exempt, abandoned, or excluded property. Yet the IRS provides inadequate guidance to its employees trying to collect from the value of this property, which can lead to irrational case decisions. Moreover, IRS policies that allow a notice of federal tax lien to indefinitely remain on file (based on a subjective determination that has no checks or balances), can needlessly harm a taxpayer's ability to make a fresh start outside of bankruptcy.

Analysis

Current IRS procedures place a heightened emphasis on automatically pursuing collection from exempt, abandoned, or excluded property post-discharge while failing to provide adequate instruction to IRS employees on the valuation of these assets. Moreover, IRS policies encourage allowing pre-petition NFTLs to remain on file (sometimes indefinitely if the taxpayer owned real property) when all the underlying taxes have been discharged, even though there may be no collection potential or planned collection activity. The determination to do so is made without any managerial oversight and the IRS does not revisit or track the lien unless the taxpayer submits full payment or requests another type of lien certificate (*e.g.*, discharge, subordination, or withdrawal), or the statutory period of limitations for collection action expires. Finally, a review of current post-bankruptcy procedures and communication efforts reveals that the IRS often falls short of properly educating and working with taxpayers to help them resolve their dischargeable and non-dischargeable tax debts.

Recommendations

The National Taxpayer Advocate recommends the IRS develop and implement explicit guidance requiring managerial approval of all post-discharge lien retention determinations; track how many liens survive bankruptcy, how many are later released, and how much revenue is collected as a result of leaving these liens on the taxpayers' assets and use these data to analyze the effectiveness of the program; permit revenue officers to retain control over nondischargeable debts while investigating collection potential from exempt, abandoned or excluded assets; work with the U.S. Bankruptcy Courts to include stuffers to be sent out with notices that contain information on tax debts during and after bankruptcy; and revise demand letters to provide taxpayers with better information about both their dischargeable and nondischargeable debts.

Tax Administration Issues

17. Ponzi Schemes Present Challenges for Taxpayers and the IRS

Problem

The infamous Madoff Ponzi scheme – reportedly involving over $50 billion and 15,400 investors – came to light in late 2008. This single scheme had the potential to increase the dollar amount of theft loss claims more than 15-fold. Ponzi schemes create problems for both taxpayers and the IRS. When Ponzi victims learn that previously-reported investment income does not actually exist and they have lost much or all of their initial investment, they face a number of tax-related questions. Tax-exempt victims may also face tax reporting and compliance questions.

Analysis

The IRS addressed some Ponzi-related questions by posting frequently asked questions on its website and issuing Revenue Ruling 2009-9, which answers some legal questions, and Revenue Procedure 2009-20, which provides a safe harbor that allows victims to sidestep a number of difficult factual issues. The IRS also established a Ponzi schemes steering committee and working group. The working group issued a draft report recommending the IRS issue additional guidance. The IRS generally responded to the Madoff scheme very well, but its recent guidance still does not answer many of the Ponzi-related tax questions, such as:

- How indirect investors – those who invested through intermediaries – are to be treated for tax purposes;
- When to amend prior-year returns to eliminate "phantom income" – income taxpayers reported but never received (including what documentation would establish the phantom income was not constructively received);
- How to report any clawbacks (*i.e.*, the legal requirement to repay distributions from the Ponzi scheme as part of a bankruptcy proceeding);
- How these same rules apply to private foundations;
- How to apply the private foundation distribution rules; and
- How private foundations may avoid the jeopardy tax.

Less noteworthy Ponzi schemes surface on a regular basis. Without additional guidance, victims of these schemes will continue to face complicated tax questions at a time when they can least afford expensive tax advice. Answering Ponzi-related questions one at a time is not the best approach for the long term.

Recommendations

The National Taxpayer Advocate recommends that the IRS publish additional guidance, or at least publish answers to more of the most common questions, and also consider the Ponzi Schemes Working Group's recommendations.

18. IRS Power of Attorney Procedures Often Adversely Affect the Representation Many Taxpayers Need

Problem

Tax professionals play a significant role in tax administration by facilitating return processing and representing taxpayers in audits and controversies. When the IRS fails to timely recognize a valid power of attorney (POA), taxpayers may experience difficulties. IRS processing of POAs also harms taxpayers in cases where the IRS improperly bypasses the designated representative or does not notify a taxpayer-employer about a change of address initiated by a third party payer.

Analysis

IRS employees cannot discuss taxpayer issues with a tax professional without confirmation that the taxpayer has authorized a designated representative. The IRS utilizes a system called the Centralized Authorization File (CAF) to keep track of POAs. IRS policy is to send all original correspondence to the taxpayer and provide a copy to the taxpayer's authorized representative unless the taxpayer has indicated otherwise. However, certain automated systems (such as the Automated Offer in Compromise and the Automated Lien System) are not linked to the CAF, which causes delays in sending copies of IRS correspondence to taxpayers' representatives.

The IRS systems cannot distinguish cases where a POA is applicable to only one taxpayer on a joint return. Due to this limitation, the IRS may be affecting the rights of the unrepresented spouse by treating the representative as though he or she represents both spouses. The IRS is aware of this systems flaw and is working on reprogramming systems to allow for separate POAs for each spouse on a joint return.

The Low Income Taxpayer Clinic program helps qualifying organizations provide assistance to low income taxpayers in resolving tax disputes with the IRS for free or a nominal fee. Some clinics are associated with a law or accounting school, with students working under the supervision of a faculty member. If a student is unable to fully resolve the taxpayer's issue(s) before the semester is up, the LITC often will transfer the case to another student volunteer. Current POA guidelines make such transfers burdensome and time-consuming, exacerbating the tax complications for low income clients.

Recommendations

The National Taxpayer Advocate recommends that the IRS systemically upload taxpayer representative information directly from the CAF to the other automated systems such as the ALS; develop additional guidance and procedures to manually input and monitor the POA information; allow LITC directors to renew and revoke their student representatives' authorizations simply by submitting the changes in writing without submitting a new Form 2848; assign a CAF unit employee dedicated to LITC POA issues; establish a cost-effective process for gathering and measuring taxpayer and POA complaints on direct contact violations; and implement dual address change letters alerting employers that a third party has initiated a change of address in cases where the third party has access to the client employer's funds.

19. The IRS Mismanages Joint Filers' Separate Accounts

Problem

Taxpayers who file joint returns are jointly and severally liable for any deficiency or tax due, and the IRS usually maintains a single account to keep track of their joint liability. Sometimes, however, the IRS creates separate accounts for joint return filers to accommodate changes in the taxpayers' circumstances. Taxpayers are harmed when the IRS mismanages these separate accounts, designated as MFT 31 accounts (or on occasion as Non Master file or NMF accounts).

Analysis

IRS systems are unable to determine the extent to which the IRS fails to properly create separate accounts for joint filers. Even when it properly creates separate accounts in response to a triggering event, the IRS may miscalculate the period of limitations on collection with respect to a separate account or may apply payments to the wrong account, and an IRS taxpayer assistor may not realize that separate accounts exist. These malfunctions may lead to impermissible collection activity and confusion about the existence or amount of the taxpayer's liability. Finally, the IRS may improperly disclose one joint filer's personal information to the other filer's representative.

Recommendations

The National Taxpayer Advocate recommends the IRS develop a system to ascertain whether to create an MFT 31 or NMF account in response to a triggering event and report when a required account is not opened. Moreover, the IRS should monitor those accounts closely to ensure that they correctly reflect payments and collection action is not improper.

20. Targeted Research and Increased Collaboration Needed to Meet the Needs of Tax-Exempt Organizations

Problem

Tax-exempt organizations must meet tax compliance and reporting obligations that can be surprisingly complex. Smaller organizations, which constitute the majority of the tax-exempt sector, are more likely to face this complexity without the assistance of professional tax preparers. The IRS acknowledges that small exempt organizations (EOs) need special help complying with the tax law, but it has no way to obtain comprehensive information about the services EOs need from the IRS or how they prefer to receive them. Further, the informational and educational needs of 1.8 million diverse tax-exempt organizations are primarily supported by nine IRS employees in the Exempt Organizations Customer Education and Outreach group within the Tax Exempt and Government Entities division. The "research gap" regarding the characteristics of the EO population, together with this inadequate staffing level, places the IRS in the position of using a one-size-fits-all, Internet-based approach to delivering service and helping organizations understand their reporting responsibilities.

Analysis

In early 2005, roughly half of all EOs were staffed entirely by volunteers and another third had fewer than ten employees. Surveys indicate that organizations are dealing with their own fiscal stress by eliminating or decreasing staff positions and relying more heavily on volunteers to carry out administrative functions, including tax compliance activities. The purpose of a Taxpayer Assistance Blueprint, like the one the IRS developed for individual taxpayers, is to provide a methodology for obtaining comprehensive information about the service needs and preferences of a specific taxpayer population. With this information, the IRS could design a specific plan to address the needs identified, and provide assistance, outreach, and support designed to meet the needs and preferences of specific segments of the tax-exempt population. The IRS should pay special attention to the educational needs of small and newly formed organizations that rely on volunteers to provide services and remain compliant.

Recommendations

The National Taxpayer Advocate recommends that the IRS design and implement an Exempt Organization Taxpayer Assistance Blueprint to formulate a targeted outreach plan based on research, and use the resulting data to justify an increased level of funding for outreach and education to EOs, including a stronger presence in local communities.

21. The IRS Should Develop an In-House Cognitive Research Lab to Understand Taxpayer Behavior and Devise More Effective Products and Programs

Problem

The IRS does not adequately test its products, programs, and assumptions prior to releasing notices, forms, or educational products to the public, or before embarking on new programs and changing processes or procedures that affect the ways in which the IRS interacts with taxpayers. Testing should be conducted in a Cognitive Research Lab prior to release or implementation in order to test assumptions and make adjustments based on the reactions of different taxpayer populations to the item or programs being tested. Failure to do so results in the IRS continuing to release products, programs, and initiatives without having tested the methods or assumptions made in developing them to determine if the approach is truly effective.

Analysis

A Cognitive Research Lab would permit the IRS to use professionals such as psychologists, sociologists, behavioral economists, ethicists, and others in combination with research staff to conduct tests with taxpayers and observe reactions to products, forms, notices, programs, and assumptions while these items are being developed. Such testing would assist the IRS in the early development stages rather than encountering issues after a product, program, notice, or form has been released to the public.

Recommendations

The National Taxpayer Advocate recommends that the IRS enhance the effectiveness of tax administration by establishing a Cognitive Research Lab and collaborating with the National Taxpayer Advocate to study existing government and private sector cognitive labs, identify IRS employees who could be trained to staff the lab, and hire staff externally who provide skills and disciplines not otherwise available to the IRS.

Status Updates

IRS's Identity Theft Procedures Require Fine-Tuning

Problem

Identity theft occurs in tax administration when an individual intentionally uses the Social Security number of another person to file a false tax return or fraudulently gain employment. When these types of identity theft occur, the victim often begins a journey through IRS processes and procedures that may take years to complete.

Update

The National Taxpayer Advocate applauds the IRS's recent improvements in procedures to assist victims of identity theft. For example, in September 2008 the IRS established a centralized unit dedicated to assisting identity theft victims, who can call a toll-free hotline (800-908-4490) to report their problems, obtain information, and take steps to protect their accounts.

This centralized unit provides two essential services to identity theft victims. First, it serves as a central point of contact that interacts with other parts of the IRS as appropriate. Second, the unit conducts a global account review to identify all federal tax issues related to the identity theft and ensures that the responsible IRS functions have taken the appropriate actions to resolve the victim's tax account issues.

In 2008, the IRS began marking the accounts of victims with an electronic indicator if the victims provide the appropriate documentation of identity theft (a copy of a police report or identity theft affidavit, plus photo identification). In 2009, the IRS began to apply a series of filters known as "business rules" to any return filed with an SSN associated with a marked account. Business rules give the IRS an automated means of distinguishing valid returns from fraudulent ones.

In this Status Update, we describe some of the challenges the IRS faces as it begins to:

- Apply business rules to filter out fraudulent returns associated with accounts marked with the identity theft indicator;
- Provide global account review and monitoring for all identity theft victims; and
- Accept certain identity theft cases that historically have been worked by TAS.

Federal Payment Levy Program: IRS Agrees to Low Income Taxpayer Filter

Problem

Over the past several years, the National Taxpayer Advocate has expressed serious concern about the IRS's administration of the Federal Payment Levy Program (FPLP). The FPLP is an automated system that allows continuous levies to be issued for up to 15 percent of federal payments due to taxpayers who have unpaid federal tax liabilities.

While FPLP levies can attach to a variety of federal sources of income, ranging from salaries to retirement income to federal contractor (or vendor) payments, the bulk of FPLP levy payments have historically been related to Social Security benefits. Although the FPLP initially employed an income filter to systemically exclude taxpayers with income below a specified threshold, the IRS gradually phased out the filter and eliminated it altogether in January 2006.

The IRS committed to work in partnership with TAS on a research project to determine whether effective income and hardship filters could be created and implemented. However, the initial TAS and IRS effort to develop a filter did not yield an agreement as to the correct approach.

Update

After publication of the TAS study in the 2008 Annual Report to Congress, the National Taxpayer Advocate and the Director of Compliance in the IRS Wage and Investment Division met regularly to explore how to incorporate the TAS filtering model into existing IRS systems. We are pleased that the IRS has agreed to implement the low income filter (LIF) in January, 2011 for taxpayers receiving Social Security benefits. The LIF will exclude taxpayers from the FPLP if their estimated income is less than 250 percent of the poverty level guideline. The National Taxpayer Advocate commends the IRS for its efforts to protect taxpayers and looks forward to working with the IRS to monitor the effectiveness of this filter.

Legislative Recommendations

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(VIII) requires the National Taxpayer Advocate to propose legislative recommendations to resolve or mitigate problems encountered by taxpayers. This year's report makes the following 11 recommendations (including a suite of five collection-related protections in recommendations 4-8):

1. Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing

Problem

The IRS currently processes income tax returns before it has a chance to process information returns, including Forms W-2, *Wage and Tax Statement,* and Forms 1099, which report the amount of interest, dividends, and other payments. This sequence makes little sense. From a taxpayer perspective, the sequence leads to millions of cases where taxpayers inadvertently make overclaims that the IRS does not identify until months later, exposing the taxpayer not only to a tax liability but to penalties and interest charges as well. From the government's perspective, this sequence creates opportunities for fraud and requires the IRS to devote resources to retrieving refunds that should not have been paid and that it often cannot recover. This sequence also prevents the IRS from making pre-populated returns available as an option to taxpayers.

Analysis

The IRS currently does not begin to match income reported on information returns against income reported on tax returns until after the filing season has ended. There are two overriding reasons for this delay. First, the deadline for filing Forms W-2 and most Forms 1099 is March 31 – after most tax returns have been filed. Second, the tax filing season currently starts in mid-January, which makes it impossible for the IRS to receive and process information documents before it processes tax returns.

Recommendation

The National Taxpayer Advocate recommends that Congress direct the Treasury Department to prepare a report identifying the administrative and legislative steps required to allow the IRS to receive and process information reporting documents before it processes tax returns. The Treasury Department should be given a full year to prepare its report in light of the complexity of the issue and the actions that would be required of the IRS, the Social Security Administration, private employers, and financial institutions. The goal should be to fully implement required changes within five years of the time the report is completed.

2. Strengthen the Independence of the IRS Office of Appeals and Require at Least One Appeals Officer and Settlement Officer in Each State

Problem

The Office of Appeals does not have an appeals officer or settlement officer in nine states. Appeals generally holds face-to-face hearings at the Appeals office closest to the taxpayers' residence or business. However, Appeals may hold conferences at other sites when feasible and necessary to provide a convenient conference opportunity. Appeals does not provide telephonic or correspondence hearings at the offices closest to the taxpayers when requested.

The IRS has recently required all business units, including Appeals, to permit new employees from other business units to share any available workstations. In at least one situation, the IRS required new employees from its compliance function to use workstations in shared space with Appeals employees. Such an arrangement fosters the perception of a lack of independence and may compromise *ex parte* provisions.

Analysis

Nine years ago, the GAO reported that the IRS was actively assigning appeals officers to each state and considering video conferencing in rural or remote areas to implement § 3465(b) of RRA 98. However, Appeals has yet to adopt either requirement.

Appeals' independence in fact and in appearance is necessary to protect a taxpayer's right to a fair and impartial hearing. Recent intrusions by IRS employees on Appeals workspace threaten its independence and a taxpayer's ability to detect *ex parte* communications. Appeals' declining independence may cause taxpayer dissatisfaction, and as a consequence, taxpayers may bypass Appeals altogether in favor of noncompliance or litigation.

Recommendation

The National Taxpayer Advocate recommends that Congress require Appeals to have at least one appeals officer and settlement officer located and regularly available within every state, the District of Columbia, and Puerto Rico; ensure taxpayer access to telephonic, correspondence, or face-to-face hearings with the local Appeals office upon request; and provide that each Appeals office maintain separate office space, separate phone, facsimile, and other electronic communication access, and a separate post office address from any IRS office co-located with the Appeals office.

3. Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income

Problem

Damages or payments received as a result of a lawsuit or settlement agreement on account of personal physical injury or physical sickness are excluded from income tax. However, damages or payments for mental anguish, emotional distress, pain, and suffering – which are not awarded on account of physical injury or physical sickness – are includible in gross income. The difference in the tax treatment of physical and mental suffering was codified in 1996 when Congress amended Internal Revenue Code § 104(a)(2) to authorize an exclusion from gross income solely of payments attributed to physical injury or physical sickness. Thus, for example, if a taxpayer is awarded compensation for depression due to sexual harassment in the workplace, the award attributable to that compensation would be includable in gross income.

Analysis

Mental anguish, emotional distress, and pain and suffering can be caused by a physical/chemical condition and may produce physical symptoms as well. Over the past few years, doctors and researchers have made significant advances in identifying changes that occur in the brain when a person is plagued by mental illness.

Although it is increasingly accepted in the medical community that mental illness is caused by physical/chemical abnormalities or changes in the body and may produce physical symptoms – effectively blurring the line between physical and mental suffering – the law continues to treat taxpayers differently according to their illness.

Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC §104(a)(2) to exclude from gross income payments received as a settlement or judgment for mental anguish, emotional distress, and pain and suffering.

Collection Protections (Recommendations 4-8)

4. Strengthen Taxpayer Protections in the Filing and Reporting of Federal Tax Liens

Problem

Current law does not require the IRS to verify the existence or the value of a taxpayer's property before filing a notice of federal tax lien (NFTL) in the public record, nor does it specify the factors the IRS must consider in making lien filing determinations. As a result, the IRS files most NFTLs automatically, without substantive human review, after a simple verification that the amount due is correct. An imprudent NFTL filing has the potential to badly damage the financial welfare of the taxpayer and simultaneously reduce future tax receipts from that taxpayer for years to come. In addition, the absence of statutory reporting periods for unpaid tax liens or lien events leads to inconsistent treatment of different lien events by credit reporting agencies and causes unnecessary financial distress for affected taxpayers.

Analysis

The NFTL filing and the information contained on the notice are included in consumer (credit) reports and therefore may impair a taxpayer's ability to obtain financing, find or keep a job, and secure affordable housing or insurance. When a taxpayer has little or no ability to pay the tax owed and has no assets from which to collect, an NFTL filing may further impede the taxpayer's financial viability and ultimately undermine tax revenue and future compliance. For these reasons, the IRS should not automatically file NFTLs but instead should carefully consider and balance these competing interests. In addition, the Fair Credit Reporting Act (FCRA) only provides a statutory reporting period for "paid" tax liens. As a result, an unpaid lien may remain on a credit report indefinitely, even when the underlying lien becomes unenforceable. The FCRA also does not regulate the reporting periods for lien events contemplated by the tax code, such as lien withdrawals, lien releases, lien discharges, and self-releasing or erroneous liens.

Recommendations

The National Taxpayer Advocate recommends that Congress amend the tax code to provide clear and specific guidance about the factors the IRS must consider in making NFTL filing determinations; allow for pre-filing administrative review of IRS lien determinations by the IRS Office of Appeals; and permit civil actions for damages in connection with improper NFTL filings or the IRS's failure to make the required NFTL determinations. The National Taxpayer Advocate further recommends amending the FCRA to set specific timeframes for reporting derogatory tax lien information on credit reports.

5. Impose Collection Protections on Refund Offsets for EITC Recipients

Problem

The complexity involved in claiming the earned income tax credit (EITC) can undercut the program's intended purpose by leading well-intentioned taxpayers into financial hardship. Because the EITC is designed to benefit low income taxpayers, many taxpayers whose EITC claims are initially paid and then denied on audit have already spent their refunds. Other low income taxpayers may have liabilities as a result of IRS document matching or incorrect treatment as an independent contractor (and thus subject to self-employment tax). If the taxpayer has no means of paying the tax owed, the IRS will offset future refunds, potentially including the entire EITC portion of these refunds. Thus, the taxpayer could lose 100 percent of the EITC to which he or she would otherwise be entitled in a given year, due to the refund offset to satisfy a previous debt.

Analysis

The United Kingdom (UK) has enacted protections to prevent the government from offsetting tax refunds attributable to certain tax credits. Her Majesty's Revenue and Customs (HMRC) is generally restricted in the amount of credit it can offset to satisfy a previous year tax debt. Specifically, if HMRC determines that a taxpayer overclaimed a tax credit in a previous open year, the agency will collect the overpayment by reducing the claimant's payment for the current year. However, the UK has a graduated set of limits, with the default limit set at 25 percent, on the amount of the credit payments HMRC is permitted to offset in a given year.

The National Taxpayer Advocate recommends that, like the UK, Congress should limit the amount of the current year federal tax refund attributable to EITC the IRS can offset to satisfy a governmental debt. Specifically, Congress should prohibit the IRS from offsetting more than 15 percent of the portion of the refund attributable to the EITC. Congress has already determined the 15 percent figure to be an appropriate ceiling for Social Security payments in the FPLP program. In fact, the EITC population is analogous to the population receiving Social Security benefits. Thus, the 15 percent limitation deemed appropriate for FPLP is equally appropriate in refund offsets of EITC proceeds.

Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC § 6402 by adding language to limit the amount of the tax refund attributable to the EITC that the Secretary can offset pursuant to IRC §§ 6402(a) through (e). The provision should prohibit the Secretary from offsetting the refund by more than 15 percent of the portion attributable to the EITC.

6. Apply Uniform Limits and Extensions to Levy Actions on Social Security Benefits

Problem

The IRS levies Social Security benefits either by issuing a paper levy to the Social Security Administration (SSA), for up to 100 percent of the taxpayer's payments (less any exemptions), or by systemically issuing a levy through the Federal Payment Levy Program (FPLP) to receive 15 percent of the payments (without exemptions). Taxpayers whose incomes are at or below 250 percent of the poverty level may suffer economic hardship due to FPLP levies. Further, current law provides insufficient protections and clarity for Social Security beneficiaries with tax liabilities. The IRS generally has ten years from the date of the assessment to collect the tax by levy. The IRS may, however, continue collection after the collection statute expiration date by issuing a paper levy before the CSED expires. A levy served prior to the CSED may be updated post-CSED to reflect accruals of penalty and interest due as of the date of the final payment for any period listed on the levy, turning taxpayers into "tax debtors for life."

Analysis

Social Security provides *90 percent or more* of total income for 35 percent of beneficiaries aged 65 or over. The current regime for levies on Social Security benefits, involving paper and FPLP levies, are inconsistent and can potentially harm low income Social Security recipients. While we commend the IRS for agreeing to establish a "filter" in the near future to exclude low income Social Security recipients from automated FPLP levies, the IRS is under no legal obligation to use or retain such a filter. Moreover, under current law, the IRS may issue a paper levy to reach all of a taxpayer's Social Security benefits. Absent a cap on the percentage of benefits that may be levied, low income taxpayers may experience the very harm Congress sought to avoid under the FPLP. Further, the IRS continues to use its discretion to issue paper levies to offset the Social Security benefits of low income taxpayers outside of the FPLP post-CSED. Post-CSED levies of Social Security benefits may harm taxpayers who are currently compliant and are relying on Social Security in retirement. When the IRS levies on Social Security benefits, taxpayers may be financially unable to make payments that exceed the interest accrual associated with their underlying tax liabilities. Unless circumstances change to enable a taxpayer to pay down the tax debt, such taxpayers would be indebted to the IRS forever.

Recommendation

The National Taxpayer Advocate recommends that Congress enact legislation to provide for a low income filter for the FPLP, make levies on Social Security benefits subject to a uniform exemption amount, limit post-CSED collection of Social Security benefits by paper levies to taxpayers who exhibit flagrant conduct, and eliminate post-CSED accruals of interest and penalties on these levies.

7. Allow Taxpayers to Raise Relief under Internal Revenue Code Sections 6015 and 66 as a Defense in Collection Actions

Problem

Several district courts have not permitted taxpayers to raise relief from joint and several liability under the innocent spouse provisions of IRC § 6015 as a defense in collection suits. Other statutory provisions and judicial precedent make clear that taxpayers may raise IRC § 6015 in a variety of contexts, and IRC § 6015 (e)(1)(A) permits an individual to seek relief from joint liability by petitioning the United States Tax Court, "in addition to any other remedy provided by law."

Analysis

At least two district courts that refused to allow the IRC § 6015 defense in collection suits asserted that the claims could still be raised in other forums. IRC § 6015(g)(2), however, provides that a final court decision in a prior proceeding for the same taxable year is conclusive with respect to the qualification of a taxpayer as an innocent spouse if the taxpayer meaningfully participated in the prior proceeding. Therefore, if those taxpayers had sought IRC § 6015 relief in U.S. Tax Court after the district court decisions became final, the Tax Court might also have refused to hear their IRC § 6015 claims. In 2009, a taxpayer raised the IRC § 6015 defense in a district court suit, and the court stayed the case so the Tax Court could hear the claim. The Tax Court, however, held that it lacked jurisdiction. Taxpayers need clarification regarding whether they can raise this defense in collection suits in any district court.

Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC §§ 6015 and 66 to clarify that taxpayers may raise relief under those sections as a defense in a proceeding brought under any provision of Title 26 (including §§ 6213, 6320, 6330, 7402, and 7403) or any case under title 11 of the United States Code.

8. Eliminate the Suspension of the Collection Statute During Qualified Hospitalization Resulting from Service in a Combat Zone

Problem

The IRS generally has ten years from the date of assessment to collect a tax liability. However, the IRS may not collect the liability and the ten-year period is suspended while taxpayers are serving in a combat zone or are hospitalized as a result of combat zone duty. Although the IRS is not statutorily barred from collecting while a civilian is in the hospital, it often defers collection. Significantly, however, the period for collection is not suspended during this hospitalization. Thus, the statutory collection period may expire on the hospitalized civilian's tax liabilities but not on the liabilities of a taxpayer hospitalized due to combat service.

Analysis

Under present law, the IRS is not entitled to more time to collect from taxpayers who are hospitalized for activities not related to combat activities. While the IRS has the discretion to suspend collection administratively, doing so does not extend the period for collection. In certain circumstances, then, the IRS has more time to collect from hospitalized troops who have served the United States in combat than it would have to collect against similarly situated civilians.

Recommendations

The National Taxpayer Advocate recommends that Congress amend IRC § 7508(a) to eliminate the suspension of the collection statute during any period of qualified hospitalization after service in a combat zone or performance of combatant activities in a contingency operation.

9. Provide a Uniform Definition of a Hardship Withdrawal from Qualified Retirement Plans

Problem

The Internal Revenue Code contains over a dozen tax-advantaged plans and arrangements to encourage taxpayers to save for retirement. These tax-advantaged retirement planning vehicles are subject to differing sets of rules regulating eligibility, contribution limits, tax treatment of contributions and distributions, withdrawals, availability of loans, and portability. Particularly confusing are the rules governing certain distributions from qualified plans that are made before age 59½. Further, even if a plan allows for a hardship withdrawal, participants must deal with inconsistent rules for triggering the ten percent additional tax for early withdrawal imposed by IRC § 72(t).

Analysis

While some retirement plans allow for an early withdrawal upon the event of a hardship, the various plans do not uniformly apply these so-called "hardship withdrawal" provisions. For example, 401(k) plans can allow participants to take an early distribution of their elective deferrals while still employed with the employer maintaining the plan "upon hardship of the employee," but such distributions are still subject to the ten percent additional tax on early distributions if made before age 59½. Participants in 457(b) plans (which cover state and local government employees) may take an early distribution of their entire benefit for "unforeseeable emergencies," and those distributions, like all 457(b) distributions, are exempt from the ten percent additional tax. Individual retirement accounts (IRAs) are not required to limit the distributions to the account beneficiary. Therefore, an individual could receive an IRA distribution for events that would be a hardship under the 401(k) or 457(b) rules.

By establishing uniform rules for the availability and tax consequences of hardship withdrawals from qualified retirement plans, Congress will reduce complexity, eliminate meaningless distinctions between the types of plans offered by different types of employers, and prevent taxpayer confusion and the imposition of unnecessary penalties.

Recommendations

The National Taxpayer Advocate recommends that Congress establish uniform rules regarding the availability and tax consequences of hardship withdrawals from tax-advantaged retirement plans and arrangements. Hardship withdrawals should be permitted when a participant is faced with an "unforeseeable emergency." The National Taxpayer Advocate further recommends that such hardship distributions be exempt from the ten percent additional tax imposed by IRC § 72(t).

10. Provide a Fixed Statute of Limitations for U.S. Virgin Islands Taxpayers

Problem

Many U.S. citizens who believe they are residents of the U.S. Virgin Islands (USVI) have an unexpectedly long statute of limitations (SOL) on tax assessments or none at all. The IRS reached different conclusions at least two times about the extent to which USVI residents have the benefit of a statute of limitations. Its latest reversal came after some taxpayers improperly claimed tax benefits designed by Congress to attract businesses to the islands. The end result is that the IRS has singled out a small group of USVI taxpayers for special treatment – the very types of taxpayers that federal tax incentives are seeking to attract to the USVI – by eliminating the SOL applicable to them but not the SOL applicable to other similarly situated taxpayers.

Analysis

The IRS's reversals unintentionally send the message that the IRS might arbitrarily eliminate the benefit of any statute of limitations by singling out those who take advantage of legitimate tax incentives. Perceptions of arbitrary and unfair tax administration not only undermine the purpose of tax incentives designed to attract business to the USVI, but may also increase controversy and diminish the public's willingness to comply with the law, potentially reducing federal tax receipts. It is also inefficient for IRS agents to examine old years because they have to review old documents, apply old laws, and work with taxpayers who are less able or inclined to cooperate by producing old documentation. Such inefficiencies mean the IRS will not close as many examinations as it would if it focused on more recent returns. Indeed, these audits are taking 82.7 percent longer than comparable audits and IRS Revenue Agents are assessing $439 less per hour than the nationwide average. Taxpayers are also disputing these assessments 41 percent of the time as compared to the national average of 14 percent for non-USVI cases.

Recommendations

The National Taxpayer Advocate recommends that Congress provide that the filing of a return with the USVI by a person claiming to be a *bona fide* USVI resident starts the statute of limitations period to the same extent filing with the IRS does. This change should be retroactive so that old returns for which the SOL would have expired will be closed unless the IRS makes an assessment within 90 days after enactment. As a correlative matter, we recommend that Congress require the USVI to automatically provide copies of returns filed with its Bureau of Internal Revenue to the IRS within a reasonable period of time.

11. Increase the Threshold for the Election to Claim the Foreign Tax Credit Without Filing Form 1116 for Individuals and Index It for Inflation

Problem

The Foreign Tax Credit (FTC) contains detailed and complicated limitation and "income basket" provisions, which for individual taxpayers are difficult to understand and comply with in full. An individual taxpayer may elect to claim the FTC for any tax year without applying the limitations or filing Form 1116, *Foreign Tax Credit,* if his or her creditable foreign taxes for the year relate exclusively to qualified passive income, are not more than $300 ($600 if filing a joint return), and certain other criteria are met. However, inflation has eroded the value of the $300/$600 threshold, which has not been adjusted since 1997. In addition, more taxpayers are being exposed to the FTC limitation and have to claim FTC on Form 1116 because of falling dollar exchange rates and increased investments in mutual funds holding foreign investments.

Analysis

Had the threshold been indexed for inflation, it would have risen to $404 ($808 for jointly filed returns) in 2009. By increasing the amount from $300 to $500 for individual taxpayers, and from $600 to $1,000 for joint filers, this legislative recommendation would reduce burden for 152,404 taxpayers (or over five percent of all Form 1116 filers) based on tax year 2008 data.

Recommendation

The National Taxpayer Advocate recommends that Congress amend IRC § 904(k)(2)(B) to increase the threshold amount for creditable foreign taxes on qualified passive income to $500 ($1000 if filing a joint return) and index this amount for inflation in $50 increments.

The Most Litigated Tax Issues

Internal Revenue Code (IRC) § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify the ten tax issues most often litigated in the federal courts and to classify those issues by the category of taxpayer affected. The cases we reviewed were decided during the 12 months that began on June 1, 2008, and ended on May 31, 2009. In addition, the report contains a discussion of certain judicial decisions that did not involve one of the ten most frequently litigated issues but were significant because of their holdings.

1. Appeals from Collection Due Process Hearings Under Internal Revenue Code Sections 6320 and 6330

Collection Due Process (CDP) hearings were created by the IRS Restructuring and Reform Act of 1998 (RRA 98). CDP hearings provide taxpayers with an independent review by the IRS Office of Appeals (Appeals) of the decision to file a lien or the IRS's proposal to undertake a levy action. In other words, a CDP hearing gives taxpayers an opportunity for meaningful hearings in front of appeals officers *before* the IRS proceeds with collection. At the CDP hearing, the taxpayer has the statutory right to raise any relevant issues related to the unpaid tax, the lien, or the proposed levy, including the appropriateness of collection action, collection alternatives, spousal defenses, and under certain circumstances, the underlying tax liability.

Taxpayers have the right to judicial review of Appeals' determinations provided they timely request the CDP hearing and timely petition the court. Generally, the IRS suspends collection action during the hearing and any judicial review that may follow.

Since 2003, CDP has been one of the tax issues most frequently litigated in the federal courts and analyzed for the National Taxpayer Advocate's Annual Report to Congress. The trend continues this year, with the courts issuing at least 170 opinions during the review period of June 1, 2008, through May 31, 2009. The cases discussed demonstrate that the CDP process serves an important function by providing taxpayers with a forum to raise legitimate issues before the IRS deprives them of property. Many of these decisions provide guidance on substantive issues. Where taxpayers attempted to use the process inappropriately, courts imposed sanctions or warned taxpayers about the possibility of sanctions being imposed in the future.

2. Summons Enforcement Under Internal Revenue Code Sections 7602, 7604, and 7609

The IRS may examine any books, records or other data relevant to an investigation of a civil or criminal tax liability. The IRS may serve a summons for this information directly on the individual who is the subject of the investigation or any third party who may possess relevant information.

A person who has a summons served upon him or her may contest the legality of the summons if the government petitions a court to enforce it. If the IRS serves a summons upon a third party, any person entitled to notice of the summons may challenge its legality by filing a motion to quash or by intervening in any proceeding regarding the summons. Generally, the burden on the taxpayer to establish the illegality of the summons is formidable. We reviewed 158 federal court opinions discussing issues related to IRS summons enforcement during the 12 months from June 1, 2008, through May 31, 2009. The party contesting the summons prevailed in full in only four of these cases, with one resulting in a split decision, two resulting in no decision, and the IRS prevailing in 151 of the 158 cases.

3. Trade or Business Expenses Under Internal Revenue Code Section 162 and Related Sections

The deductibility of trade or business expenses is perennially among the ten most litigated tax issues in the federal courts. We identified 112 cases that included a trade or business expense issue and were litigated between June 1, 2008, and May 31, 2009. The courts affirmed the IRS position in the majority (approximately 65 percent) of cases, while taxpayers prevailed about five percent of the time. The remaining cases resulted in split decisions.

4. Gross Income Under Internal Revenue Code Section 61 and Related Sections

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the most litigated issues in each of the National Taxpayer Advocate's Annual Reports to Congress. For this report, we reviewed 109 cases decided between June 1, 2008, and May 31, 2009. Some gross income issues in these cases include:

- Damage awards;
- Foreign earned income;
- Discharge of indebtedness; and
- Qualified scholarships.

Overall, taxpayers prevailed in full or in part in only six cases.

5. Accuracy-Related Penalty Under Internal Revenue Code Section 6662

Sections 6662(b)(1) and (2) authorize the IRS to impose a penalty if under § (b)(1), a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if under § (b)(2), an underpayment of tax exceeded a computational threshold called a substantial understatement. Section 6662(b) also authorizes the IRS to impose three other accuracy-related penalties. However, during our review period of June 1, 2008, through May 31, 2009, taxpayers litigated these other penalties less frequently than the negligence and substantial understatement penalties; therefore, this analysis does not address the three other accuracy-related penalties.

6. Frivolous Issues Penalty Under Internal Revenue Code Section 6673 and Related Appellate-Level Sanctions

During the 12 months between June 1, 2008, and May 31, 2009, the federal courts issued decisions in at least 49 cases involving the IRC § 6673 "frivolous issues" penalty, and at least 13 cases involving an analogous penalty at the appellate level. These penalties are imposed against taxpayers for maintaining a case primarily for delay, raising frivolous arguments, unreasonably failing to pursue administrative remedies, or filing a frivolous appeal. In four of the 34 cases where IRC § 6673 was at issue in the United States Tax Court or a United States District Court, taxpayers escaped liability for the penalty but were warned that they could face sanctions for similar conduct in the future. Similarly, we identified one case at the appellate level where the court did not impose a sanction under IRC § 7482(c)(4) or any other authority, but did warn the taxpayer that similar future conduct will result in a sanction. Nonetheless, we include these cases in our analysis to illustrate what conduct will and will not be tolerated by the courts.

7. Civil Actions to Enforce Federal Tax Liens or to Subject Property to Payment of Tax Under Internal Revenue Code Section 7403

Section 7403 authorizes the United States to file a civil action in a United States District Court against a taxpayer who has refused or neglected to pay any tax, to enforce the federal tax lien or to subject any of the delinquent taxpayer's property to the payment of the tax. We identified 61 opinions issued between June 1, 2008, and May 31, 2009, which involved civil actions to enforce federal tax liens under IRC § 7403. The courts affirmed the position of the United States in the majority of cases. Taxpayers prevailed in only six cases and four cases resulted in split decisions. This is the first year that civil actions to enforce federal tax liens under IRC § 7403 have appeared as a Most Litigated Issue in the National Taxpayer Advocate's Annual Report to Congress.

8. Failure to File Penalty Under Internal Revenue Code Section 6651(a)(1) and Estimated Tax Penalty Under Internal Revenue Code Section 6654

We reviewed 60 decisions issued by the federal court system from June 1, 2008, to May 31, 2009, regarding the addition to tax under IRC § 6651(a)(1) for failure to timely file a tax return, or the addition to tax under IRC § 6654 for failure to pay estimated income tax. The phrase "addition to tax" is commonly referred to as a penalty, so we will refer to these two additions to tax as the failure to file penalty and the estimated tax penalty. Twenty cases involved imposition of the estimated tax penalty in conjunction with the failure to file penalty, five cases involved only the estimated tax penalty, and the remaining 35 cases involved only the failure to file penalty.

The failure to file penalty is mandatory unless the taxpayer can demonstrate the failure is due to reasonable cause and not willful neglect. The estimated tax penalty is mandatory unless the taxpayer can meet one of the statutory exceptions. In the cases analyzed, taxpayers were largely unsuccessful in their attempts to avoid the failure to file penalty or the estimated tax penalty.

9. Family Status Issues Under Internal Revenue Code Sections 2, 24, 32, and 151

Because family status issues center on the exemptions, credits, and filing status claimed on federal tax returns, litigated cases in this area often involve multiple issues with similar factual determinations. This report combines the following issues into a single "family status" category:

- Head of household filing status;
- Child tax credit;
- Earned Income Tax Credit (EITC); and
- Dependency exemption.

We reviewed 48 federal court opinions issued between June 1, 2008, and May 31, 2009. This is the first time in four years that we have observed an increase in the number of opinions in family status cases. Over the past three years, the figure has declined, from 46 in the National Taxpayer Advocate's 2006 Annual Report to Congress to 41 in the 2007 report and 34 in 2008. Many of these opinions cover multiple family status issues, with the determination of one often affecting others. For example, a denial of the dependency exemption will lead to the summary denial of the child tax credit and may impact eligibility for head of household filing status.

10. Relief from Joint and Several Liability Under Internal Revenue Code Section 6015

Married couples may elect to file their federal income tax returns jointly or separately. Spouses filing joint returns are jointly and severally liable for any deficiency or tax due. Joint and several liability permits the IRS to collect the entire amount due from either taxpayer.

Section 6015 provides three avenues for relief from joint and several liability. Section 6015(b) provides "traditional" relief for deficiencies. Section 6015(c) also provides relief for deficiencies for certain spouses who are divorced, separated, widowed, or not living together, by allocating the liability between each spouse. Section 6015(f) provides "equitable" relief from both deficiencies and underpayments, but only applies if a taxpayer is not eligible for relief under IRC § 6015(b) or (c). A taxpayer generally files Form 8857, *Request for Innocent Spouse Relief*, to request relief.

We reviewed 42 federal court opinions involving relief under IRC § 6015 that were issued between June 1, 2008, and May 31, 2009. Most significantly, courts addressed three important procedural issues this year: the period of time within which a taxpayer may request relief under IRC § 6015 (f); the evidence the U.S. Tax Court can consider when reviewing an IRC § 6015 determination; and the standard by which the Tax Court reviews IRC § 6015(f) determinations. An additional three cases reiterated that taxpayers in community property states are not entitled to refunds of taxes paid with community property even if they obtain relief under IRC § 6015 with respect to those taxes. Finally, the Tax Court noted that the issue of whether IRC § 6015 can be raised as a defense in a collection suit persists.

Volume 2: Research and Related Studies

Volume two of the report contains in-depth studies that TAS has conducted or commissioned on important tax administration issues. This year's report contains five such studies:

1. The IRS's Use of Notices of Federal Tax Lien

Background

A tax lien is a legal tool the IRS uses to facilitate the collection of unpaid tax debts. A notice of federal tax lien (NFTL) places the public on notice that the IRS has a legal claim to taxpayers' property as security or payment for their tax debt. The IRS frequently files liens using a systematic process that does not take into account the individual circumstances of the taxpayer (*e.g.*, the taxpayer may have an economic hardship, and the filing of the lien may actually be detrimental to the collection of the liability).

The IRS issued nearly one million liens in fiscal year (FY) 2009. This was an increase of 85 percent from the number of liens filed in FY 2005 and about 475 percent from FY 1999. By comparison, the number of balance due individual returns (Forms 1040) filed from FY 2005 to FY 2009 rose only 24 percent. For FY 2009, liens made up over 4,000 of the cases worked by TAS, placing this inventory category in the top one-third of TAS receipts. The National Taxpayer Advocate is concerned that the IRS's use of the NFTL is harming taxpayers, especially those with economic hardships, while not significantly enhancing the IRS's ability to collect delinquent liabilities.

Analysis

The TAS Research & Analysis staff analyzed data from taxpayers with liabilities in tax year (TY) 2002. As part of this study, TAS Research reviewed nearly 1.9 million transactions (payments credited to taxpayers' accounts using transaction codes) involving over 270,000 taxpayers who incurred delinquent TY 2002 liabilities. The 270,000 taxpayers studied did not have any outstanding tax liabilities at the time their TY 2002 delinquency arose. TAS Research & Analysis examined the subsequent payment history of these taxpayers, along with how the IRS recorded their payments, to explore the relationship between revenue collection and the use of the NFTL. The research objectives for this project included:

- How often is the NFTL effective in securing payment on the tax debt?
- What amounts of the tax payments are not attributable to the NFTL?
- Does increasing the number of tax liens filed increase tax revenue?
- What percentage of NFTLs are filed systemically?
- How many NFTLs are filed against taxpayers who are incurring a hardship?

The IRS codes for more than half of all the payments made by these taxpayers were insufficient to determine the source of the payment. Consequently, less than half of the delinquent payments definitively identified the payment source. Ultimately, nearly $905 million of payments from these taxpayers were traceable. Given the traceable payment sources, we found:

- Payments associated with liens amount to less than $1 out of every $5 of payments.
- Payments that came from sources other than liens accounted for over $4 out of every $5 the IRS collected.

We also found that the IRS has continued to increase the number of NFTLs filed, but that there has not been any real increase in dollars collected (*i.e.,* the total collection yield):

- The IRS increased the number of liens filed by 475 percent between FY 1999-2009.
- During FY 1999-2009, when adjusted for inflation, the total dollars IRS collected actually declined by seven percent from $29.4 billion to $27.2 billion (in terms of real dollars valued as of 2009).

The IRS generates a majority of its liens through its Automated Collection System (ACS). Just under two-thirds of the liens requested by ACS were made systemically (*i.e.*, the IRS generates these liens without determining whether the taxpayers have any assets or are likely to acquire any assets to which the NFTL would attach). As an example, NFTLs are automatically requested for every taxpayer whose delinquency exceeds $5,000 when the IRS determines that the liability is currently not collectible (CNC). The CNC designation includes situations where the IRS has determined that the collection of the liability would create a hardship on taxpayers by leaving them unable to meet necessary living expenses. For taxpayers with accounts in CNC status due to economic hardship, we found:

- IRS refund offsets were responsible for nearly $6 out of every $10 in payments collected from taxpayers.
- NFTLs were responsible for $2 out of every $10 in payments collected from taxpayers.

Recommendations

In light of the aforementioned findings, we make the following recommendations:

- The IRS should discontinue the policy of automatic NFTL filing on CNC hardship accounts with an unpaid balance of $5,000 or more.
- The IRS should base lien filing determinations for all IRS contact employees on a thorough review of all the taxpayer's circumstances (including the existence and the value of assets, the taxpayer's financial information, the existence and amount of non-tax debt, and the ramifications of the lien on the taxpayer's credit rating).

- The IRS should institute a quality review of payment coding used to track taxpayers' payments for tax liabilities. An accurate method of tracking payments is an essential first step in determining the impact of various collection tools on taxpayers and the efficacy of their use.
- The IRS should study whether lien payments from CNC hardship taxpayers impose an economic hardship on these taxpayers.

2. Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge Facing the IRS

Background

The TAS Research & Analysis staff examined the subsequent compliance behavior of individual taxpayers who incurred failure-to-pay delinquencies in 2002 following the last recession. The study included only taxpayers who had no prior unpaid tax liabilities at the time that they acquired their delinquencies. We chose this group because we believe its subsequent compliance behavior is indicative of the likely subsequent compliance behavior of the many taxpayers entering into delinquency during the current economic downturn.

The study tracked the compliance history of this cohort of taxpayers from the time their delinquencies began in 2002 through the first quarter of 2009. We explored the following questions:

- Was the IRS effective at keeping taxpayers compliant after the initial IRS disposition of their original liabilities?
- Does a financial analysis based solely on IRS allowable living expense (ALE) standards adequately capture the taxpayer's financial situation, or does it contribute to subsequent noncompliance?

The study then briefly reviewed conditions in the current environment to assess the compliance challenges confronting taxpayers and the IRS.

Analysis

Taxpayers whose accounts were placed in the IRS Collection queue or in CNC status at first disposition had high levels of subsequent noncompliance. In addition, all taxpayers whose liabilities reached taxpayer delinquent account (TDA) status and were worked in the Automated Collection System or by the Collection Field function (CFf) had especially high levels of subsequent noncompliance, regardless of their dispositions, as did taxpayers who had cancellation of debt income (CODI) or who experienced bankruptcy at any time during the study period.

- **Taxpayers placed in queue:** About 54 percent of these taxpayers had subsequent payment delinquencies. About 76 percent had at least one subsequent payment delinquency or unfiled return.
- **Taxpayers placed in CNC status due to hardship:** About 45 percent of these taxpayers had subsequent payment delinquencies. About 59 percent had at least one subsequent payment delinquency or unfiled return.
- **Taxpayers whose liability reached ACS or CFf:** Slightly over half of these taxpayers had subsequent payment delinquencies. About 74 percent had at least one subsequent payment delinquency or unfiled return.

- **Taxpayers who had CODI or experienced bankruptcy:** Over 61 percent of these taxpayers had subsequent payment delinquencies. About 68 percent had at least one subsequent payment delinquency or unfiled return.

A simulated financial analysis based on the ALE standards shows that taxpayers (particularly those whose accounts were placed in CNC status, received CODI, or experienced bankruptcy) have financial obligations that are not included in the standard ALE analysis. This finding suggests that many taxpayers may have liabilities that the IRS will not allow in its calculation of the taxpayers' ability to pay (*i.e.*, unsecured debt, or housing expenses that exceed the ALE allowance).

These liabilities could contribute to subsequent noncompliant behavior, since the amount the taxpayer is required to pay to the IRS may put some taxpayers in the position of deciding which creditor they will pay.

Recommendations

The National Taxpayer Advocate recommends that the IRS study a representative sample of taxpayers with new payment delinquencies to determine the extent to which they have liabilities that are not allowed under current ALE standards. The study should also evaluate whether IRS installment agreement (IA) policies would cause these taxpayers to default on non-IRS liabilities.

If the study results confirm that current IRS IA policies are problematic, the National Taxpayer Advocate recommends that the IRS conduct a pilot study in which taxpayer payment agreements are based on a comprehensive review of the taxpayer's financial situation, with due consideration to all debts.

The National Taxpayer Advocate also recommends that the IRS study the use of collection alternatives, such as the offer in compromise program and partial payment installment agreements, in lieu of placing taxpayers in CNC status. The agreements could be structured to have a finite duration and a flexible payment schedule contingent on the taxpayer's ability to pay throughout the duration of the agreement. The emphasis would be on ensuring that taxpayers remain current on future tax liabilities through the establishment of adequate withholding or periodic direct-debit estimated payments (*e.g.*, on a bi-weekly or monthly basis) for self-employed taxpayers.

3. An Analysis of Tax Administration Issues Raised by a Consumption Tax, Such as a National Sales Tax or Value Added Tax (VAT)

Background

In connection with her testimony before the President's 2005 Advisory Panel on Federal Tax Reform, the National Taxpayer Advocate articulated a set of core taxpayer-centric principles to help ensure the tax system is administrable and minimize opportunities for noncompliance and conflict with the IRS. This report highlights the tax administration aspects of various consumption tax proposals that make them more or less administrable in light of these basic principles. The National Taxpayer Advocate is not taking a position with respect to the imposition of any new tax.

Members of Congress introduced at least six bills proposing a VAT or modified VAT in the first half of 2009 alone, but these taxes are rarely called VATs. For example, the business component of most flat taxes is a modified VAT. This report discusses three broad types of consumption tax – a credit invoice method VAT, a subtraction method VAT, and a national retail sales tax (RST).

A VAT is like a sales tax collected at each stage of production. For example, if gasoline sells for the total of the value added by an oil producer, refiner, distributor, and gas station, a small tax would be due from each. An RST, however, would place the entire burden of collection on the retailer – the gas station in this example.

Under the credit invoice method, a business collects and pays VAT reflected on its sales invoices, but then claims an offsetting credit (called an input credit) for VAT shown on its purchase invoices. By contrast, under a subtraction method VAT, the tax is not reflected on invoices. A business subtracts deductible purchases from gross receipts to compute "value added," and then applies the VAT rate. Thus, it is similar to a corporate income tax, except that capital investments are typically deductible and wages and interest are not.

Analysis

Our review of available research suggests the following:

First, a credit invoice method VAT may promote voluntary tax compliance better than a comparable subtraction method VAT or RST. Because business buyers claim credits for VAT shown on purchase invoices under a credit invoice method VAT, they have an incentive to ensure that the seller's invoices properly reflect the VAT. If a business's tax liabilities (or credits) are correctly reflected on invoices, tax preparation could involve the simple exercise of adding up the tax (or credit) shown on the invoices. The possibility that the IRS could easily audit these invoices may also discourage underreporting and minimize opportunities for noncompliance.

Second, establishing only one rate and limiting tax preferences would minimize compliance costs and opportunities for noncompliance. Multiple rates and preferences increase complexity, recordkeeping requirements, compliance costs, tax sheltering opportunities, and disputes about whether transactions qualify for the reduced rate or preference.

Third, a credit invoice method VAT or RST applicable to imports but not exports (*i.e.*, a "destination-based" tax) could reduce the need for complex international tax rules. A destination-based tax would not require many of the foreign tax credit and transfer pricing rules that are needed under an origin-based tax such as the income tax. Because foreign tax credit and transfer pricing rules are a source of complexity, controversy, and recordkeeping burden, a destination-based tax that did not require them could significantly reduce administrative problems, compliance burdens, and opportunities for noncompliance.

Fourth, at low rates, the administrative costs of an RST may be lower than for a VAT, but a VAT may be less expensive if high rates are needed. Businesses that do not make retail sales are generally not required to file or pay an RST. Under a VAT, however, these businesses would still have to file returns and pay the tax, making a VAT more burdensome for them. As tax rates rise, however, if the revenue lost to noncompliance and correlative enforcement costs and burdens rise at a faster rate for an RST than for a VAT, these benefits may be more than offset by enforcement costs and burdens.

Fifth, a federal RST or credit invoice method VAT could leverage and accelerate state RST coordination and simplification efforts. To the extent Congress could use the uniform definitions, sourcing rules, forms, and procedures provided by the Streamlined Sales and Use Tax Agreement for a credit invoice method VAT or RST, it would be relatively easy for states to conform their sales and use taxes to the national RST or VAT tax base. Such conformity could provide opportunities to reduce compliance burdens as well as public and private costs to administer both federal and state taxes.

Recommendation

If Congress considers the imposition of a national RST or other VAT-like tax, the National Taxpayer Advocate recommends that lawmakers consider the administrative issues highlighted in this report to ensure that any resulting legislation is administrable.

4. Running Social Programs Through the Tax System

Background

A government can distribute social benefits through either a direct spending program or a tax expenditure. Tax expenditures are social benefit programs channeled through the tax system and take a variety of forms: (1) income exclusions, exemptions, and deductions (2) preferential tax rates; (3) tax credits, and (4) deferrals of tax. Refundable tax credits are a favored means of delivering social benefits and implementing policy. In fact, Congress recently created and expanded several refundable credits in the American Recovery and Reinvestment Act of 2009 and the Worker, Homeownership, and Business Assistance Act of 2009.

Analysis

Refundability is necessary where Congress decides to provide a benefit through the tax system to individuals who do not have tax liabilities. Where noncompliance exists, however, our analysis finds that the refundability component of a tax credit is not the main driver of the noncompliance. IRS data show noncompliance is a significant problem with many types of tax incentives and is not necessarily more prevalent with refundable credits. Rather, several other design elements in existing refundable credit programs make them susceptible to noncompliance. For example, fact-and-circumstance-based eligibility criteria make it hard for the IRS to verify eligibility before it releases the benefit. In addition, the target population may have difficulty navigating the complex eligibility requirements and benefit calculations. Further, the large monetary value of some benefits makes them more attractive to fraudulent schemes and increases the demand for commercial refund delivery products.

Recommendation

To structure an effective tax-based social benefit program, policymakers must understand the needs of the target population as well as the strengths and limitations of the proposed program administrator. In this report, the National Taxpayer Advocate suggests various design elements for policymakers to consider to assist them in enacting programs that maximize both participation and compliance.

5. Taxpayer Advocate Service Survey of Federal Government External Ombudsmen

Background

In 2003, the Taxpayer Advocate Service published a report titled *Independent Advocacy Agencies Within Agencies: A Survey of Federal Agency External Ombudsmen.* Since then, many federal external ombudsmen offices have been created, either legislatively or administratively. In 2007, the National Taxpayer Advocate conducted another survey, covering ombudsmen from the previous report along with newly created or identified ones. Our current report attempts to categorize federal external ombudsmen within the tenets of the American Bar Association's core ombudsmen principles of independence, confidentiality, and impartiality.

Analysis

Federal external ombudsmen exist in many structures, sizes, authorities, and scopes, with minimal uniformity between offices. Most federal external ombuds offices are created administratively and thus lack sufficient structure and protection to provide independence from the parent agency. The ombudsman function varies widely between agencies, with little consistency even between ombudsmen of the same types. Between legislatively created and agency-initiated ombudsmen, the differences in safeguards are even greater. Lacking the basic protections necessary to their function, ombudsmen can be viewed as extensions of the parent organizations, unfunded, and removed.

Recommendation

The National Taxpayer Advocate recommends that Congress enact an overarching ombudsman act, providing minimum standards for any federal external ombudsman. Such an act could relieve many concerns that arise when an ombudsman office is closely tied to a parent agency. Not only would such an act serve to protect ombudsmen, but it could also assure customers that the ombudsman is independent from the parent agency and operates without interference, thus strengthening the ombudsman role.

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