NATIONAL TAXPAYER ADVOCATE

2004 ANNUAL REPORT TO CONGRESS

TAXPAYER ADVOCATE

INTERNAL REVENUE SERVICE

SERVICE

VOLUME 1

This Report is dedicated to Arlene Kay, the first Executive Director of Systemic Advocacy in the Taxpayer Advocate Service.

Her retirement deprives taxpayers of a tireless advocate on their behalf and deprives TAS and the IRS of a leader who balances integrity with humor. We will miss her.

Honorable Members of Congress,

It is my pleasure to submit to you for your review the National Taxpayer Advocate's Annual Report to Congress. In this year's report, we highlight the impact of tax law complexity on tax administration. The report is a little different in format from previous years in that we have carried this theme – tax administration in a complex and changing tax environment – throughout each of the report's sections. Particularly in the Most Serious Problems section, we look at the impact of complexity and the challenges of the 21st century with respect to each aspect of the tax system, from the taxpayer's perspective.

Given the current debate about tax reform, we believe that this is a particularly appropriate time to make a comprehensive review of IRS operations, to acknowledge and praise its successes, and to identify significant challenges. We hope this information is useful to policy-makers as they consider tax law simplification and reform. Certainly, reform efforts must take into account the impact of such proposals on the IRS and the IRS' ability to fairly and effectively administer any changes.

To be sure, this report documents many success stories. As we note in the Legislative Recommendations section, there has been significant activity on the legislative front. Most notably, we now have a uniform definition of a child for five of the most basic family status provisions in the Internal Revenue Code.[1] Three other proposals we recently recommended have become law – an "above-the-line" deduction for contingent attorney fees and attorney fee awards in certain nonphysical personal injury cases,[2] authorization for the IRS to enter into partial-pay installment agreements,[3] and the availability of income averaging for commercial fishermen.[4]

There is, however, one nagging problem that has not been adequately addressed – the Alternative Minimum Tax (AMT) for individuals. The need for AMT relief looms like the proverbial elephant in the room, and for that reason we once again, for the third year, recommend its repeal.[5] We also present nine other legislative recommendations, some proposing simplification, some addressing taxpayer rights, and still others that are technical in nature.

PREFACE

---

[1] Working Families Relief Tax Act, Pub. L. No. 108-311, § 201 (2004); *see* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), 78.

[2] American Jobs Creation Act, Pub. L. No. 108-357, § 703 (2004); *see* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), 160.

[3] American Jobs Creation Act, Pub. L. No. 108-357, § 843 (2004); *see* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), 210.

[4] American Jobs Creation Act, Pub. L. No. 108-357, § 314 (2004); *see* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), 226. In addition, at least a dozen of our recommendations have passed either the full House as part of H.R. 1528, the Taxpayer Protection and IRS Accountabilty Act, or the full Senate as part of S. 882, the Tax Administration Good Government Act.

[5] *See* Key Legislative Recommendation, AMT, *infra.*

The IRS has had its share of successes, too. For example, the IRS is actively addressing noncompliance by Federal contractors, a problem we highlighted in last year's report.[6] It is continuing to improve its toll-free phone service, and will be able to track causes of taxpayer "call abandons" in real time.[7] The IRS is initiating important innovations in correspondence imaging which should significantly reduce the number of lost or misplaced taxpayer submissions and correspondence, and lead to quicker processing and responses.[8] The IRS outreach and education functions – particularly Stakeholder Partnership Education and Communication (SPEC) and Taxpayer Education and Communication (TEC) – continue to improve in their ability to reach their respective taxpayer populations.[9]

On the Earned Income Tax Credit (EITC) front, the IRS is to be commended for finally, after almost thirty years, developing a strategic vision and plan for how to implement this program, under the oversight of a single EITC Program Director and Program Office. The IRS is now doing the kind of basic research and testing that was so sorely needed in the past. Despite its controversial nature, this research will enable the IRS to increase compliance *and* participation, while eliminating taxpayer burden and inadvertent errors. Moreover, the IRS, to its great credit, is discontinuing use of the "combination letter" in EITC correspondence audits and has significantly improved the quality and clarity of many EITC letters and notices.[10] Over the last year, the IRS has worked more extensively in partnership with Low Income Taxpayer Clinics, the Taxpayer Advocacy Panel, and other stakeholders to ensure that their concerns are taken into account when making changes and proposing initiatives.

Thus, for the first time ever, we are not listing the Earned Income Tax Credit as a Most Serious Problem of taxpayers.[11] This is not to say, however, that EITC administration is without any problems. In fact, we are releasing as Volume II of this report an IRS research study, conducted by the Office of the Taxpayer Advocate (OTA) with assistance from the Wage and Investment Office of Research that we believe has far-reaching implications for the tax system.[12] What the study empirically demonstrates is that, on average,

---

[6] *See* Federal Contractors and the Federal Payment Levy Program (FPLP) *infra*. *See also* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 262-63, 267.

[7] *See* Taxpayer Access – Remote Interaction, *infra*.

[8] *See* Processing Individual Taxpayer Identification Number (ITIN) Applications and Amended Related Federal Income Tax Returns, *infra*.

[9] *See* Education and Outreach Issues in A Complex and Changing Tax Environment, *infra*.

[10] *See* Most Serious Problem, Lack of Notice Clarity, *infra*, and National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 87.

[11] EITC has been reported as a problem since the inaugural Taxpayer Advocate's report in 1996.

[12] National Taxpayer Advocate, *Annual Report to Congress Volume II – The National Taxpayer Advocate's Earned Income Tax Credit (EITC) Audit Reconsideration Study*, Publication 2104 (Rev. 12-2004).

43 percent of taxpayers who sought reconsideration of audits that disallowed the EITC in whole or in part received additional EITC as a result of the audit reconsideration, and that where the taxpayer received additional EITC, he or she received, on average, 94 percent of the EITC amount claimed on the original return. Moreover, when Taxpayer Advocate Service (TAS) employees initiated contact with taxpayers by phone instead of relying solely on correspondence, the likelihood of a taxpayer receiving additional EITC increased with the number of phone calls made by the TAS employee.[13]

The findings of the EITC Audit Reconsideration Study actually bring me to a discussion of the challenges that the IRS faces as it administers the tax system in the 21st century. The IRS constantly feels the press of having to do too much with too little. As budget constraints limit its ability to hire new collection and examination employees and to replace retiring employees, the IRS tries to create workforce savings and efficiencies by eliminating or minimizing processes that require human intervention or contact. This approach is appropriate for programs involving submission and correspondence processing, where e-filing and correspondence imaging improve both accuracy of tax return data – eliminating errors attributable to keystrokes – and processing times. But in the Examination and Collection functions, the movement away from direct human interaction can create problems for the tax system as well as for taxpayers. The EITC Audit Reconsideration Study clearly demonstrates this fact.

The Office of the Taxpayer Advocate is focusing on several primary challenges to the IRS as it wrestles with maintaining a balance between taxpayer service and taxpayer rights on the one hand, and a vigorous examination and collection presence on the other.[14] These concerns are:

- The impact of program centralization on customer service and taxpayer interaction;
- The substitution of automated processes for human interaction; and
- The level of corporate-wide support for "safety valves" for IRS processes and programs, including Collection Due Process hearings, Offers-in-Compromise, the Taxpayer Advocate Service, and a truly independent Office of Appeals within the IRS.

Let us consider the Offer-in-Compromise (OIC) program, which is identified as a Most Serious Problem and is the subject of a legislative recommendation herein, in light of these three concerns. The OIC program is, in essence, an equitable remedy that takes into account the particular facts and circumstances of the individual taxpayer and

[13] *See* National Taxpayer Advocate, *Annual Report to Congress Volume II – The National Taxpayer Advocate's Earned Income Tax Credit (EITC) Audit Reconsideration Study*, Publication 2104, (Rev. 12-2004). The study reviewed an equal number of EITC audit reconsideration cases worked solely by the IRS Correspondence Examination function, which rarely calls the taxpayer, and cases worked by the Taxpayer Advocate Service and then decided by IRS Correspondence Examination. TAS employees made, on average, two contacts (either by phone or by letter) with the taxpayer after the initial contact letter, while IRS Correspondence Examination made only one contact per two taxpayers.

[14] We discuss our concerns with respect to IRS Examination and Collection strategy in two Most Serious Problems, *infra*.

attempts to come up with a resolution that results in a payment that is less than the amount legally due and owing. By definition, OIC cases will require more attention and more resources than "batch processing" programs like Automated Collection System and correspondence examination. And yet the majority of OIC cases are worked in the campus environment where IRS employees are rarely encouraged to pick up the phone and call taxpayers to clear up matters, and are trained to process documents according to strict procedures, without exercising individual discretion. If the IRS does not train its OIC employees in campuses about the exercise of judgment and does not permit them to call taxpayers and discuss their cases with them, then the centralization of OIC cases subverts the purpose of the OIC program.[15]

The IRS' responses to the Most Serious Problems, including the OIC response, suggest that the IRS does not adequately recognize that programs such as OIC or TAS – regardless of the small number of cases they represent in comparison to the overall casework of the IRS – actually are the backbone to taxpayer compliance. Thus, the IRS dismisses the National Taxpayer Advocate's concerns about the implementation of the OIC program by pointing out that OIC cases constitute less than one percent of IRS collection cases and less than two percent of TAS cases. These observations miss the point of the OIC program.

Safety valves such as OIC, Collection Due Process, TAS, and an independent Appeals Office are available when all the IRS' dotted i's and crossed t's don't provide adequate relief.[16] These safety valves make taxpayers feel that the tax system is, after all, ultimately fair and balanced. All the enforcement initiatives in the world will not reassure taxpayers about the fairness of the tax system if there is no well-developed mechanism for dealing with IRS errors, or taxpayer mistakes and special situations. These mechanisms are absolutely essential given the mind-numbing complexity of the tax law and the tax system.

In closing, I note that the IRS has repeatedly assured both Congress and taxpayers that its current restoration of an enforcement presence, which I believe is both necessary and appropriate, will not come at the expense of customer service. Yet, in many of the Most Serious Problems we address, there is evidence that the IRS may be reducing customer service in order to shift existing resources to the Examination and Collection functions. For example, in the Taxpayer Assistance Centers (TACs), the IRS is requiring its employees to undertake examination and collection duties. Since TACs are not receiving additional

[15] Throughout this Most Serious Problems section, the IRS' responses question the relevance of TAS cases to a problem analysis by saying or implying that the number of TAS cases is nominal and not large enough to be representative of the overall taxpayer population. Congress apparently thinks otherwise. In IRC § 7803(c)(2)(B)(ii)(II), Congress requires the National Taxpayer Advocate to report on recommendations made by persons with the authority to issue Taxpayer Assistance Orders (i.e., the National Taxpayer Advocate and the Local Taxpayer Advocates). TAS employees are instructed to identify systemic problems raised in their casework. TAS then conducts substantial research before identifying something as a *systemic* problem. In fact, the IRS has no other comparable way of capturing detailed information about taxpayer problems.

[16] For a detailed discussion of each of these programs, *see* Most Serious Problems, Offers in Compromise, Appeals Independence and Access to the Taxpayer Advocate Service; and Key Legislative Recommendations, Collection Due Process Hearings and Offer In Compromise: Effective Tax Administration.

resources to conduct these additional activities, face-to-face prefiling customer service will necessarily be reduced while face-to-face enforcement resources will increase.[17] In the year to come, the Office of the Taxpayer Advocate will be monitoring these developments closely to see that taxpayer rights and taxpayer service are not, in fact, impaired.

Over the next few years, Congress and the IRS face a lot of challenges. Congress has directed the National Taxpayer Advocate to identify certain of those challenges that pose serious problems for taxpayers and advocate on the taxpayers' behalf. The critique that follows is not a condemnation of the IRS, no matter how strongly we disagree with the IRS at times. The IRS does an extraordinary job at an almost impossible task. But the National Taxpayer Advocate's job is to challenge the IRS to do better. This report – with its discussion of the most serious problems, its legislative recommendations for reducing complexity, and its identification of litigated cases that could not otherwise be resolved – is intended to advance the dialogue over tax law and tax administration simplification. We hope it is helpful.

Respectfully submitted,

Nina E. Olson

National Taxpayer Advocate

31 December 2004

[17] *See* Taxpayer Access – Face-to-Face Interaction, *infra*. We are not saying that providing taxpayers with face-to-face assistance on collection or examination issues is wrong; rather, we are expressing concern that providing such assistance, when not accompanied by additional funding, will dilute the level of non-enforcement face-to-face assistance available at the TACs.

TABLE OF CONTENTS

CONTENTS

PROBLEM

TOPIC #1 MOST SERIOUS PROBLEM: THE CONFOUNDING COMPLEXITY OF THE TAX CODE

DEFINITION OF PROBLEM

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

ANALYSIS OF PROBLEM

Section 7803(c)(2)(B)(ii)(IX) of the Internal Revenue Code requires the National Taxpayer Advocate's Annual Report to Congress to "identify areas of the tax law that impose significant compliance burdens on taxpayers or the Internal Revenue Service, including specific recommendations for remedying these problems." Focusing on the tax system as a whole, this is an easy mandate to fulfill: Without a doubt, the largest source of compliance burdens for taxpayers and the IRS alike is the overwhelming complexity of the tax code, and without a doubt, the only meaningful way to reduce these compliance burdens is to simplify the tax code enormously. In the balance of this part of the report, we identify and discuss 20 additional serious problems encountered by taxpayers, as required by IRC § 7803(c)(2)(B)(ii)(III). Most serve as case studies that illustrate the consequences of tax law complexity.

The Internal Revenue Code now consists of substantially more than a million words.[1] The most obvious consequence of complexity, of course, is that taxpayers and practitioners often struggle to figure out what the tax laws require or permit. However, another significant, if less obvious, consequence of complexity is the enormous burden it places on the IRS as the tax administrator.

From a taxpayer perspective, understanding and complying with the laws can be nearly impossible. To cite a few examples, many low income taxpayers must grapple with the confusing requirements of the earned income tax credit (EITC) to determine whether they qualify for the EITC and, if so, how much of a credit they may claim. Yet the EITC population is low income and many qualified applicants do not speak English as their primary language, making it precisely the population least able to comprehend and substantiate compliance with the eligibility requirements.

High income and increasing numbers of middle income taxpayers are finding themselves ensnared by the alternative minimum tax (AMT). Originally enacted in 1969 to apply to wealthy taxpayers who were using loopholes to escape tax altogether, the AMT is now

[1] A study published in April 2001 by the Joint Committee on Taxation put the number of words in the Code at approximately 1,395,000. *See* Staff of the Joint Committee on Taxation, 107th Cong., Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (vol. I), 4 (Comm. Print 2001). Subsequent tax legislation has expanded the number of words considerably.

projected to affect nearly 35 million taxpayers in 2010.[2] Yet most taxpayers subject to the AMT don't know it before they prepare their taxes. As a result, many taxpayers discover too late that they underpaid their tax and are therefore subject to a penalty for failure to pay sufficient estimated tax. Indeed, taxpayers often must complete a 12-line worksheet,[3] read eight pages of instructions,[4] and complete a 55-line form[5] simply to determine whether the AMT applies. To say the least, this "surprise" factor – a direct result of the AMT's complexity – is not conducive to building public confidence in the fairness of our tax laws. In our 2003 report to Congress, we designated the individual AMT as the most serious problem facing taxpayers and provided an extensive discussion of the genesis and evolution of the AMT, the way the AMT is computed, and the significant problems created by the AMT.[6] In the Key Legislative Recommendations section of this report, we again recommend that Congress repeal the individual AMT or, if Congress determines that repeal is not feasible at this time, that it substantially revamp the AMT to achieve its original objective.[7]

Business taxpayers face an even more bewildering array of laws including, for example, a patchwork set of rules that govern the depreciation of equipment, numerous and overlapping filing requirements for employment taxes, and a vague set of factors that govern the classification of workers as either employees or independent contractors and that can keep businesses and the IRS battling each other for years with no obvious "correct" answer. To reduce the tax burdens on small businesses, this report contains a Key Legislative Recommendation setting forth a package of proposals for Congress to consider.

From an IRS perspective, the challenges resulting from code complexity are equally daunting. The IRS must find a way to digest and explain the one million-plus-word statute in a way that taxpayers can understand. It must also explain the law, and its limitations, to its own employees in a clear enough manner to enable them to assist taxpayers on the front end, and to identify and pursue violations on the back end.

Not all serious problems encountered by taxpayers are a function of the law's complexity, of course. But most of them are, at least to a significant degree.

The problems described in the balance of this part of the report are loosely grouped into five categories:

[2] Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004). These data, updated to reflect the effects of legislation enacted during the 108th Congress, project that 34.8 million taxpayers will be affected by the AMT in 2010.

[3] 2004 Form 1040 Instructions, 35.

[4] 2004 Instructions for Form 6251.

[5] 2004 Form 6251, Alternative Minimum Tax – Individuals.

[6] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 5.

[7] We also made these recommendations in our 2001 report to Congress. *See* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), 166.

1. **Customer Service.** One of the IRS's primary missions is to write tax forms and instructions in a way that is understandable to taxpayers. In our judgment, the IRS generally does an excellent job of writing forms and instructions. Yet because of the complexity of the tax code, the instructions for Form 1040 (the basic return filed by individuals) and its accompanying schedules now run 127 pages.[8] In addition, the IRS must be able to answer questions each filing season from approximately 50 million taxpayers who call the IRS toll-free assistance number[9] and from more than six million taxpayers who visit IRS walk-in sites.[10] Many of the questions deal with technical aspects of the laws that general phone assistors cannot possibly answer.

   To put this challenge in perspective, consider that major national law and accounting firms employ thousands of highly educated tax professionals who often devote hours, days, weeks, or even months to answering individual questions from their clients – and many tax professionals sub-specialize because they find that learning the entire tax code is simply too hard. To ask IRS telephone assistors to respond immediately, accurately, and comprehensively to all manner of questions is to ask the impossible. That is not to say, of course, that the IRS cannot do better. Surely, it can.

   In this section, we discuss deficiencies in the extent to which the IRS provides taxpayers with opportunities to speak with IRS employees in person, the quality of remote interaction with the IRS, the accuracy of tax law and accounts assistance, and IRS outreach and education efforts.

2. **Tax Return Preparation.** In 2003, 56 percent of all individual returns and more than 85 percent of all business returns were prepared by practitioners.[11] In addition, millions of taxpayers who did not pay practitioners spent money on software packages to assist them with preparing their returns.[12] While one might expect that high income taxpayers with extensive financial holdings would disproportionately rely on preparers, we find it particularly significant that more than 71.5 percent of low income taxpayers who claim the earned income tax credit paid money to have their returns prepared.[13] And among taxpayers who were affected by the AMT –

[8] 2004 Form 1040 Instructions.

[9] Treasury Inspector General for Tax Administration, *Taxpayers Experienced Improved Access to Toll-Free Telephone Services During the 2004 Filing Season*, Ref. No. 2004-30-144 (Aug. 2004), 13.

[10] For FY 2004, the Wage & Investment Operating Division reported a total of 7,692,059 field assistance contacts. *See* Wage and Investment Operating Division, Business Performance Measurement System Report (Sept. 2004). Of those contacts, more than six million involved in-person visits.

[11] IRS Compliance Data Warehouse, Form 1040 Returns from Individual Returns Transaction File; Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, Pub. 3415 (Rev. 6-2003), 4.

[12] *See* "Individual e-filing Options," available at www.irs.gov. These data show that 14 million returns were e-filed from home computers in tax year 2003. Many more taxpayers used software packages to prepare their returns and then mailed them in.

[13] Tax Year 2003, IRS Compliance Data Warehouse, EITC IMF extract through cycle 26.

which, as noted, is projected to hit nearly 35 million taxpayers in 2010 – 75 percent used paid preparers.[14] Something is seriously wrong with a tax system so complex that a significant majority of taxpayers lack either the ability or the time to comply with it on their own.

In this section, we discuss problems with inadequate training and monitoring of return preparers, electronic tax preparation and filing, and the Volunteer Income Tax Assistance (VITA) program.

3. **IRS Processing.** Many of the processing challenges the IRS faces result more from the sheer volume of documents than from complexity, but complexity is a significant exacerbating factor. For example, the IRS sends out more than 340 notices to approximately 100 million taxpayers each year,[15] yet taxpayers frequently complain that they cannot understand what the notices say. While we strongly believe that the IRS can improve the clarity of its notices, the law often is too complex to explain in simple terms.

   In this section, we discuss problems with inconsistent campus procedures, return processing, notice clarity, miscalculation of the period of limitations applicable to collection actions, and processing issues relating to applications and returns filed by tax-exempt organizations.

4. **Tax Law Enforcement and the Tax Gap.** The IRS research function has projected that more than $300 billion a year goes unreported, under-reported, or simply unpaid.[16] The complexity of the tax code contributes significantly to the IRS's difficulty in detecting and collecting the full amount of revenue due. Indeed, the IRS is not called upon merely to enforce the code as written. In extreme cases, the IRS must go beyond the literal language of the code to make a case-by-case determination regarding the objectives of the code. On one side of the coin, taxpayers sometimes claim tax benefits based on transactions that comply literally with the code but lack substance, and the IRS attacks such transactions under a variety of doctrines, including the doctrine of "substance over form." On the other side of the coin, taxpayers sometimes find themselves in debt to the IRS due to complexities in the law (e.g., taxpayers who experienced the so-called "ISO/AMT problem") or simply dire financial circumstances, and the IRS is called upon under the offer in compromise program to try to do justice in the particular case – even if it means

[14] Tax Year 2002, IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF).

[15] Treasury Inspector General for Tax Administration, *Increased Management Attention Is Needed to Ensure the Success of Future Notice Redesign Efforts*, Reference No. 2002-30-040, 1 (Dec. 2001).

[16] *See* IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (Feb. 24, 2004). After IRS compliance efforts, the estimated "gross" tax gap of $311 billion is estimated to fall to about $255 billion. These numbers, although the best currently available, are based on old models. A new study of the tax gap is now being completed and is likely to be released in 2005.

forgiving all or part of a tax debt and allowing the taxpayer to make a fresh start. For the IRS, making case-by-case decisions in thousands of cases presenting unique sets of facts is no easy task.

To be fair, many of the enforcement challenges the IRS faces result not solely from complexity but also from resource constraints and the absence of reliable research showing how the IRS can most efficiently target its enforcement dollars. In his final report to the IRS Oversight Board, former Commissioner Rossotti discussed the critical compliance problems facing the IRS and provided a laundry list of examples (as of late 2002): 60 percent of identified tax debts are not pursued; 75 percent of taxpayers who do not file a tax return are not pursued; 79 percent of identified taxpayers who use abusive devices (e.g., offshore accounts and abusive tax shelters) to evade tax are not pursued; 56 percent of identified taxpayers with incomes of $100,000 or more and underreported tax are not pursued; and 78 percent of cases identified through document matching (10.4 million taxpayers), with estimated underreported tax of $6.96 billion, are not pursued.[17]

In the short-term, the IRS has decided to target as its number one enforcement priority corporate tax shelters and tax evasion by high income individuals.[18] In light of the extensive publicity these subjects have received and the corrosive effect that such publicity could have on tax compliance, we believe this is a reasonable approach. Indeed, most indications suggest that the IRS has been extremely successful in stopping the targeted transactions.

However, as these transactions stop and the revenue stream from IRS audits of earlier transactions begins to dry up, the IRS will need to re-evaluate how to deploy its limited enforcement resources most efficiently. By far the largest chunk of the tax gap – an estimated 67 percent – results from non-reporting and under-reporting by self-employed persons, generally on income that is not subject to information reporting.[19] There is no way that the IRS can make significant progress in reducing the tax gap unless it can develop an effective strategy to go where the money is. The greatest revenue gains may result not from the direct assessment of taxes against taxpayers who are audited but rather from the “indirect” effects that a full panoply of compliance activity has on other taxpayers who are deterred from “pushing the envelope,” or even cheating, because they fear that they, too, will be caught. Better research is needed to help the IRS target its limited resources to obtain the biggest bang for the buck in combating tax noncompliance in *all* sectors of the economy. This should be the focus of intensive IRS research now.

[17] Commissioner Charles O. Rossotti, *Report to the IRS Oversight Board: Assessment of the IRS and the Tax System*, (Sept. 2002), at 16.

[18] *IRS Strategic Plan* 2005-2009, 19.

[19] IRS National Headquarters Office of Research (unpublished projections furnished for TY 2001).

In this section, we discuss issues with the IRS examination strategy, IRS collection strategy, and reporting of payments made by federal contractors.

5. **Taxpayer Rights.** To compensate for its resource constraints, the IRS has been working increasingly to automate, centralize, and streamline its examination and collection processes. While these efforts may result in the collection of additional tax, they also have the potential to limit taxpayer opportunities to challenge IRS errors or IRS collection actions that would impose unreasonable financial hardships. As I wrote in my report last year, vigorous IRS enforcement initiatives must be balanced with an equally vigorous protection of taxpayer rights, including the delivery of outstanding customer service.[20]

   An important aspect of providing good customer service and protecting taxpayer rights is ensuring that taxpayers who experience significant hardship as a result of the way the tax laws are administered are knowledgeable about, and have access to, the Taxpayer Advocate Service (TAS). Yet a recent study found that only about four percent of taxpayers who qualify for the services of TAS contact us[21] and only a small percentage of taxpayers who qualify for TAS' services have ever heard of TAS.[22] Given TAS' central role and solid track record in assisting taxpayers, the IRS should be doing a much better job of promoting awareness of TAS.

In this section, we discuss our concerns about the independence of the Appeals function, the quality of the statutorily mandated Appeals mediation program, problems with the administration of the offer in compromise program, the extent to which IRS trains its enforcement personnel about taxpayer rights, and the lack of awareness of TAS on the part of taxpayers who qualify for TAS' services.

Clearly, the IRS has a daunting task under any circumstances, what with 130 million individual tax filers, 5.9 million corporate tax filers, 3.7 million estate and trust tax filers, and 2.4 million partnership tax filers – all interfacing at least annually with the IRS.[23] But tax law complexity begets tax administration complexity, causing frustration and disillusionment among taxpayers and imposing excessive time and resource burdens on taxpayers and the IRS alike.

[20] National Taxpayer Advocate, *Annual Report to Congress*, Pub. 2104 (Rev. 12-2003), v.

[21] Russell Marketing Research conducted a study for TAS, *Findings From Task 149 – The Taxpayer Advocate Service Research Program: With a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3*, (July 2002), and estimated that between 3.9 million and 6.6 million taxpayers were eligible for TAS' services. For simplicity, we are using the midpoint of the range, which is 5.25 million.

[22] *Id.*, at 7.

[23] IRS Data Book (FY 2003), Table 2.

PROBLEM

TOPIC A-2 MOST SERIOUS PROBLEM: TAXPAYER ACCESS – FACE-TO-FACE INTERACTION

RESPONSIBLE OFFICIAL

Henry O. Lamar, Jr., Commissioner, Wage and Investment Division

DEFINITION OF THE PROBLEM

The focus of the face-to-face service offered by the Internal Revenue Service is shifting away from information and filing assistance toward the traditional compliance roles of examination and tax collection. The IRS is directing taxpayers who seek information or tax return assistance to use self-service electronic applications, such as those provided on the IRS official website, and to use the services of volunteer tax return preparers. As part of this initiative to enhance the provision of electronic services and improve efficiency, the IRS plans to decrease the level of pre-filing services offered by Taxpayer Assistance Centers (TACs).[1] While this may increase IRS efficiency and address the growing taxpayer demand for electronic services, the IRS seems to be overlooking the needs of a segment of the taxpayer population that continues to rely on the face-to-face interaction provided by TACs.

In its latest strategic plan, the IRS establishes that one of its main objectives is to increase the number of services that are offered electronically. The IRS also notes, however, that it must "continue to use a comprehensive range of products and services to reach [their] customers, including those who do not use electronic services."[2] While the IRS has acknowledged that certain taxpayers will not utilize its electronic services, its current plan to reduce face-to-face services does not adequately provide for these taxpayers.

ANALYSIS OF PROBLEM

Background

Although this analysis will focus on the face-to-face assistance offered by TACs, formerly known as "walk-in centers," the IRS provides various forms of face-to-face interaction with taxpayers. The IRS integrates face-to-face services into each operating division, as appropriate.[3] This includes outreach, education and partnership functions; certain compliance

[1] IRS Customer Assistance, Relationships & Education (CARE) Concept of Operations, slide 9 (Oct. 10, 2003). "By FY 2007, FA provides return preparation and tax law assistance through self-service applications only (All live tax law assistance and return preparation will be provided through telephone or web chat with CAS or through partners)."

[2] Internal Revenue Service, *IRS Strategic Plan 2005-2009* (2004), 13.

[3] The Wage & Investment division (W&I) is responsible for operating TACs and providing face-to-face customer assistance. In addition, both W&I and the Small Business Self Employed (SB/SE) operating division have outreach and education groups. W&I's outreach and education group, Stakeholder Partnerships, Education & Communication (SPEC), assists individual taxpayers with their compliance responsibilities by building and maintaining partnerships with stakeholders to inform, educate, and communicate with customers. Stakeholder Partnerships, Education and Communication, SPEC Concept of Operations. SB/SE's outreach group, Taxpayer Education and Communication (TEC), assists small business and self-employed taxpayers (and their representatives) with compliance by developing educational products and services and providing pre-filing services to help the taxpayers understand and comply with the tax laws. Taxpayer Education and Communication (TEC), TEC Mission Statement; IRM 1.1.16.6(1) (February 1, 2003).

operations for audit (exam) and collection; and the services available in TACs. In 2003, almost 22 percent of IRS employees engaged in some form of face-to-face taxpayer interaction as a significant part of their duties.[4]

In general, during a typical return cycle, face-to-face interaction on a specific taxpayer's account can take place in the following contexts:

- Outreach contacts, pre-filing services or assistance with return preparation
- The review or examination of a return (an audit), and
- The collection of unpaid taxes or overdue returns.

Not every taxpayer is exposed to all three levels or requires face-to-face attention at every level. Contact with a TAC is taxpayer-initiated and is the only face-to-face interaction available for those with tax law or account questions.[5] In addition, the IRS website directs taxpayers seeking face-to-face contact to a TAC office.[6]

Traditional TAC Services

TACs have traditionally provided pre-filing services to assist taxpayers in filing their returns and paying their taxes. Taxpayers could visit an office to do any of the following:

- Pick up forms and publications,
- Seek guidance about tax laws,
- Request transcripts,
- Request account information and/or adjustments,
- Seek notice resolution, or
- Seek courtesy, need-based return preparation.[7]

These services are referred to as "front-end," because they facilitate a taxpayer's efforts to comply with federal tax laws.

[4] Table 32, Internal Revenue Service Personnel Summary, By Budget Activity and Type of Personnel, 2003 IRS Data Book, Publication 55b, 39 (Rev. 3-2004). At the close of FY 2003, the IRS had 94,638 employees. Of those, 11,513 were Revenue Agents and 5,004 were Revenue Officers. Of the total employees at the IRS, only 4,170 were dedicated to Pre-filing Taxpayer Assistance and Education.

[5] Other taxpayer-initiated face-to-face options are VITA and TCE sites, which are staffed by volunteers and not by the IRS. For a more detailed discussion of the VITA Program, see *Problems in the Volunteer Return Preparation Program*, *infra*.

[6] The IRS website declares "IRS Taxpayer Assistance Centers (TACs) are your one-stop resource for face-to-face tax help and solutions to tax problems, every business day," at http://www.irs.gov, Contact Us.

[7] *Field Assistance Concept of Operations*, 2 (August 3, 2001).

Taxpayer and Practitioner Demand for Services

The IRS faces an increasing demand for electronic products and services. Today's taxpayers are increasingly computer-literate and also work longer or non-traditional hours, leaving them little time to interact with the IRS during normal business hours.[8] In an effort to meet the taxpayers' needs, W&I is expanding its electronic options for filing, paying, communication services and other taxpayer services.[9] W&I has stated that, "[u]ltimately, we want to offer taxpayers and their representatives the ability to conduct nearly all of their interactions with the IRS electronically."[10]

As these changes take effect, the National Taxpayer Advocate is monitoring whether taxpayer needs previously met by TAC services can be adequately addressed through non-face-to-face service options. Despite the move toward electronic services and away from face-to-face interaction, W&I surveys conducted in 2002 and 2003 found that a significant majority of W&I taxpayers preferred to either contact or receive information from the IRS by conventional methods, including the face-to-face interaction offered by TACs.[11]

For purposes of the survey, conventional methods were defined as including telephone, in-person contact or regular mail.[12] Electronic methods included email or the IRS website. Taxpayers were considered to be members of the "conventional group" if they preferred to both contact the IRS and receive information by conventional means.[13] Taxpayers were considered members of the "electronic group" if they preferred to either contact the Service or receive information electronically.

According to the survey results, approximately 70 percent of W&I taxpayers belong to the conventional group.[14] Of the taxpayers surveyed, over 10 percent preferred to contact the

[8] According to IRS Commissioner Mark Everson, the reduction in the number of taxpayers utilizing the assistance of TACs stems from "streamlined services," "initiatives to educate taxpayers on alternate methods of obtaining services generally requiring a face-to-face contact" and the availability of electronic access to necessary information. Hearing on 2004 Tax Return Filing Season and the IRS Budget for Fiscal Year 2005, Subcommittee on Oversight, House Committee on Ways and Means, 108th Cong. 2nd Sess. (March 30, 2004). (Statement of Mark Everson, Commissioner of Internal Revenue)

[9] For a more detailed discussion of remote access, including toll-free customer assistance, *see* Access to Remote Interaction with the IRS, *infra*. For a more detailed discussion of tax law accuracy, *see* Accuracy of Tax Law and Accounts Assistances, *infra*.

[10] IRS Wage & Investment Division, *Strategic Assessment FY 2005*, 1.

[11] Wage & Investment, Adopters and Non-Adopters of Electronic Services Update for TAO (PowerPoint Presentation) (2003); Wage & Investment, Adopters and Non-Adopters of Electronic Services (PowerPoint Presentation), questions 83-84 (2002). In the survey, W&I does note that the population of surveyed taxpayers reached far fewer young taxpayers and more older taxpayers than W&I actually serves, however the survey results were weighted to account for this difference.

[12] Wage & Investment, Adopters and Non-Adopters of Electronic Services Update for TAO (PowerPoint Presentation) (2003); Wage & Investment, Adopters and Non-Adopters of Electronic Services (PowerPoint Presentation), slide 3 (2002).

[13] Individuals who responded that they chose to contact and receive information through "tax professionals" and "other" were included in the conventional group.

[14] In 2003, the percentage of individuals belonging to the convention group was 67.5 percent. Wage &

IRS through conventional means, but were open to receiving information electronically. The survey results can be broken down more specifically according to characteristics of W&I taxpayers:[15]

- *Age.* Younger taxpayers preferred electronic methods. The average age of the electronic group was approximately 40 years old while that of the conventional group was approximately 50. Depression and World War II generation taxpayers rarely, if ever, chose to either contact or receive information electronically.
- *Income and Education Levels.* The survey showed that the higher the taxpayer's income and education level, the more likely that he or she preferred electronic means.
- *Internet Access.* While nearly 90 percent of the electronic group had home Internet access, over 50 percent of the conventional group also had home access. Thus, Internet access is not the only factor in determining the needs of taxpayers; a person's level of comfort with the Internet also plays a role.
- *Earned Income Tax Credit (EITC) Claimants.* Of the taxpayers claiming the EITC, over 70 percent were members of the conventional group.[16]

The above survey results demonstrate a significant demand for conventional contact across a broad spectrum of W&I taxpayers. Those individuals preferring conventional contact are the taxpayers who continue to need the services of a TAC.[17] Despite this current need for face-to-face contact, W&I continues to focus on internal efficiency of service delivery and the future needs of taxpayers as they become more technologically advanced. For example, in its Fiscal Year 2005 Strategic Assessment, W&I recognizes that the elderly and disabled taxpayer populations are less likely to use the Internet, but addressed this issue by noting that the computer skills of the elderly will become on average more advanced as the baby boom generation ages.[18] This approach displays a commendable focus on preparing to meet the future needs of taxpayers, but lacks attention to the needs of the existing population who continue to need or prefer conventional contact with the IRS.[19]

Investment, Adopters and Non-Adopters of Electronic Services Update for TAO (PowerPoint Presentation) (2003); Wage & Investment, Adopters and Non-Adopters of Electronic Services (PowerPoint Presentation), slide 5 (2002). In 2002, a total of 2,822 individuals were surveyed. In 2003, a total of 2,816 individuals were surveyed. With a sample this size, the survey results are accurate within +/- 2 percent.

[15] Wage & Investment, Adopters and Non-Adopters of Electronic Services Update for TAO (PowerPoint Presentation), slides 2-6 (2003).

[16] Wage & Investment, Adopters and Non-Adopters of Electronic Services (PowerPoint Presentation), slide 10 (2002). The information from the 2003 study regarding EITC claimants was not available.

[17] *See* Internal Revenue Service Customer Satisfaction Survey - Field Assistance National Report, July-October 2003, Appendix B, Respondent Profiles by Age and Income (PowerPoint Presentation), slide B-3 (Nov. 2003) (51 percent of TAC respondents were 43 and older; 58 percent actually had income at or below below $33,000).

[18] IRS Wage & Investment Division, *Strategic Assessment, Fiscal Year 2005*, 6.

[19] IRS Wage & Investment Division, *Strategy and Program Plan FY 2003-2004, 23; Wage & Investment Strategic Assessment, Fiscal Year 2005*, 1-6.

W&I Strategic Plan

W&I has developed strategies to decrease customer burden by improving quality, efficiency and service delivery.[20] According to the W&I Strategic Assessment for fiscal year 2005, the division will implement a number of initiatives to accomplish these objectives, including "identifying less-costly methods of service delivery, expanding taxpayer self-service applications, seeking the most efficient and effective methods of responding to taxpayer demand, and finding ways to reduce taxpayer demand for services."[21]

Out-of-Scope Questions

One of the new initiatives is the proposed elimination of assistance to taxpayers with out-of-scope tax law questions at all TAC locations.[22] Instead, taxpayers will be given the Customer Account Services (CAS) toll-free number to contact for assistance.[23] The National Taxpayer Advocate is concerned that this proposal reduces the level of services to those who require face-to-face assistance with out-of-scope issues.[24] These taxpayers may not feel comfortable using the CAS number to resolve their questions. In addition, this proposal may result in disparate treatment of certain groups of taxpayers. It appears that tax law questions relevant to small business taxpayers are considered out-of-scope. This segment of taxpayers has a noted compliance problem and is responsible for a significant portion of the tax gap.[25] The IRS must carefully consider whether it is wise to turn away members of this "high risk" group of taxpayers when they voluntarily seek pre-filing assistance.

In its Field Assistance Jump-Start Kit, W&I acknowledges that "[m]any of the W&I compliance problems have less to do with tax evasion intent and more to do with misunderstanding of tax obligations."[26] Given this reality, by eliminating out-of-scope assistance at TACs, W&I is failing to provide service to those taxpayers seeking an understanding of their tax obligations.

[20] CARE Concept of Operations, slide 4 (Oct. 10, 2003) ("CARE's vision facilitates customers' ability to self-sufficiently resolve their needs and decreases the need for taxpayers to seek live assistance from IRS).

[21] IRS Wage & Investment Division, *Strategic Assessment, Fiscal Year 2005*, 1, 11.; Treasury Inspector General for Tax Administration, Accuracy Rates Have Increased at Taxpayer Assistance Centers, But Improvement Is Needed to Provide Taxpayers Top-Quality Customer Service, Reference No. 2004-40-065, 1 (Feb. 2004); S*ee also* Commissioner's Monthly Performance Business Summary, Field Assistance Accuracy, lines 91-94.

[22] Out-of-scope tax law questions are generally those that are deemed too complicated to be answered at a TAC.

[23] Taxpayers would not have access to a phone line at the TAC office and would have to make the call on their own.

[24] For a more detailed discussion of the National Taxpayer Advocate's concerns, refer to the Taxpayer Rights Impact Statement 2004-01: TAC Out-of-Scope Questions (Oct. 13, 2004).

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

[26] Wage & Investment Operating Division Field Assistance Jump-Start Kit, II-8 (Sept. 2000).

IMPACT ON CUSTOMER SERVICE

Besides the proposed elimination of out-of-scope tax law questions at all TAC locations, W&I is instituting other sweeping changes that demonstrate the shift of TAC resources away from pre-filing services, including;

- A notable decrease in overall TAC contacts;
- A reduction in the availability of return preparation appointments;
- The restricted distribution of return transcripts;
- An intention to direct resources toward examination and collection activities in the TAC; and
- The permanent closing of some TAC locations.

Notable Decrease in Overall TAC Contacts

The reduction in resources allocated to TACs has already affected the number of taxpayer contacts. At the close of fiscal year 2004, W&I has reported a 15 percent decrease in field assistance contacts from fiscal year 2003.[27] W&I attributes this decline to:

- The reduction in traffic at TACs as a result of streamlined services;
- The policy of no longer routinely providing tax return transcripts;
- Limited assistance for those requesting Individual Taxpayer Identification Numbers (ITINs); and
- The increased utilization of online services.[28]

Reduction in the Availability of Return Preparation Appointments

TACs are significantly limiting the availability of courtesy, need-based return preparation appointments available to lower income taxpayers. According to guidance issued in June, 2003, tax preparation appointments will only be available for taxpayers who have been screened in advance.[29] In addition, future appointments can only be made up to five business days in advance.[30] The availability of appointments is determined by staffing levels and other work that TAC employees must complete. To compensate for the reduction in appointments, taxpayers are directed to self-service mechanisms and volunteer return

[27] IRS Snapshot Report, Wage & Investment Performance Data (Sept. 30, 2004). For FY 2004, W&I reported a total of 7,319,493 field assistance contacts; this is down from 8,588,871 contacts in FY 2003.

[28] W&I Weekly Filing Season Highlights for Weeks Ending March 19, 2004, March 26, 2004 and May 28, 2004; see FY 2004 Field Assistance Procedural Changes, Providing the right services at the right time in the right locations, 3 (Oct. 2003) (Provides that returns will not be prepared for individuals who do not have social security numbers that match the number on the W-2 or 1099); *see also* Fiscal 2005 Appropriations: Transportation and Treasury, House Appropriations Committee, Subcommittee on Transportation and Treasury, 108th Cong. (April 21, 2004) (Statement of Mark W. Everson, Commissioner of Internal Revenue).

[29] IRM 21.3.4.10.5 (Rev. June 27, 2003).

[30] The five-day limit can be extended if necessary, due to demand. IRM 21.3.4.10.5 (Revised June 27, 2003).

preparation organizations.[31] Currently, W&I does not record the number of tax return preparation requests that are denied because no appointments are available or taxpayers fail to pass the screening process. It is not surprising, however, that the number of returns e-filed by TAC sites was down 29.7 percent for FY 2004.[32]

Restricted Distribution of Return Transcripts

Prior to October 1, 2003, TACs provided same-day, in-person service to customers requesting free tax return transcripts.[33] Taxpayers ask for these transcripts because they provide documentation for loan applications and demonstrate U.S. residency for immigration purposes, among other reasons.

In an effort to streamline services, effective October 1, 2003, TACs no longer routinely accept tax return transcript requests with the exception of extreme hardship cases.[34] A taxpayer requesting an extreme hardship exception is required to provide verification showing why he or she cannot wait the normal processing time. Examples of extreme hardship exceptions include an appointment letter from a government agency, a short deadline from a financial institution or university, or proof of denial of medical services.[35]

In the alternative, taxpayers and tax professionals now have the option to request transcripts by:

- Placing a phone call to the Telephone Routing Interactive System (TRIS) and requesting that a transcript be mailed within two weeks.
- Completing Form 4506T, Request for Transcript of Tax Return, and either dropping it off at a TAC or mailing it to one of the IRS' submission processing campuses. The transcript should be mailed within two weeks.
- Requesting a transcript online through the Transcript Delivery System (TDS) which electronically delivers the documents within 48 hours, but only to certain qualified practitioners.[36]

[31] Field Assistance, Talkpoints: Refocusing Our Resources; Fiscal Year 2003 Field Assistance Operating Procedures, Appendix C, Fiscal Year 2003 Individual Income Tax Return Preparation Procedures, C-2.

[32] E-file Reports, Non-Profit Organizations Non-Military - AdHoc Query (data source: ELF1541), TACs, All Areas, transmission date October 2, 2004. This data covers tax returns processed as of October 2, 2004.

[33] This transcript is a record of line items transcribed from the original return as filed. It does not include changes made after the transcription, such as subsequent payments, amended returns or other adjustments. FY 2004 Field Assistance Procedural Changes, 1.

[34] IRM 21.3.4.2.1 (Rev. Dec. 2, 2003).

[35] *Id.* TACs will continue to provide tax account transcripts which reflect post-filing changes as part of the Everyday Tax Solutions service. W&I Communication Strategy – TACs Eliminating Transcript Service in FY04 (Revised Oct. 25, 2004); FY 2004 Field Assistance Procedural Changes, Providing the Right Services at the Right Time in the Right Locations, 1 (Oct. 2003).

[36] FY 2004 Field Assistance Procedural Changes, Providing the right services at the right time in the right locations, 1 (Oct. 2003); W&I Communication Strategy - *TACs Eliminating Transcript Service in FY04* (Revised April 9, 2004).

While the new policy improves IRS efficiency and provides an easy and convenient solution for some practitioners, it increases the burden on many taxpayers. In the past, taxpayers were accustomed to receiving a tax return transcript from the TAC on the same day. Mail or phone requests now take approximately two weeks to deliver. Further, U.S. Citizenship and Immigration Services, mortgage lenders and other institutions will continue to refer individuals to TACs for transcripts unless they are adequately informed of the change in policy.[37]

However, account inquiries have decreased 23 percent compared with the same period last year.[38] One can only surmise that this decrease is caused, at least in part, by taxpayers experiencing difficulty in obtaining transcripts as a result of the new policy. While transcript requests have declined, the Taxpayer Advocate Service has experienced an increase in casework as a result of the change in policy. In fiscal year (FY) 2004, TAS received approximately 40 percent more cases concerning tax return copies.[39] This is an indication that the W&I emergency exception is not working properly. The National Taxpayer Advocate is concerned that W&I's definition of "emergency" is not flexible enough to cover situations in which taxpayers need immediate assistance, nor are TAC employees properly trained, much less encouraged, to identify and assist in these emergency situations.

An Intention to Direct Resources Toward Examination and Collection Activities in the TAC

During the IRS restructuring after 1998, TACs were specifically separated from the umbrella of "compliance" and instead placed under a "pre-filing" designation.[40] For fiscal year 2005, however, W&I has stated that an operational priority will be to reinstate examination and collection activities at TACs.[41] This move is intended to increase voluntary compliance. Much of the future workload of TAC employees will continue to be demand driven, in that the taxpayer chooses to visit the TAC, but employees' focus will be on accounts and collections rather than the pre-filing assistance provided at TACs.[42] This change in focus may have an adverse impact by making taxpayers more reluctant to visit these sites for information, guidance, and assistance. W&I has indicated that compliance work by the TACs will only be done outside of the filing season. However, the National

[37] W&I Communication Strategy – *TACs Eliminating Transcript Service in FY04,* April 9, 2004.

[38] Statistics come from the Account Work Notices, which capture transcript Requests, and are current as of July 30, 2004.

[39] Business Performance Management System, TAS, Case Receipts – Core Issue By Criteria Code; Issue Code 150 – Copies of Returns, Transcripts, Reports, FOIA. In FY 2004 TAS received a total of 4,081 cases on this issue, an increase over the 2,894 cases received in FY 2003.

[40] IRS Organization Blueprint, Document 11052, 2-3 (Rev. April, 2000).

[41] IRS Wage & Investment Division, Strategic Assessment, Fiscal Year 2005, 18. W&I has stated that "Field Assistance (FA) is refocusing its resources from return preparation to everyday tax solutions and one-stop quality service. The move from traditional pre-filing work to face-to-face compliance work requires FA to proactively manage customer expectations for receiving services in the future." Field Assistance, TalkPoints: Refocusing Our Resources (May 5, 2004).

[42] CARE ConOps, Appendix B; W&I CARE: Field Assistance ConOps, 3.

Taxpayer Advocate is concerned that this shift to compliance work comes at the expense of taxpayer service.

Permanent Closing of Some TAC Locations

Taxpayers are also inconvenienced by office closings, including both the permanent closing of small offices and temporary, often unannounced closures for training and other purposes, which limit the availability of face-to-face assistance.[43]

W&I has indicated that it will offer services within 45 minute commutes and will place multi-functional kiosks at key locations.[44] These kiosks are Internet enabled and provide all of the services offered at traditional walk-in sites, including return preparation, tax law assistance, ordering of forms and publications, and account management.[45]

W&I Field Assistance Operating Procedures state that kiosks "will be placed in states where delivery coverage is below 80 percent including locations where there is no TAC or the TAC has been or is being closed."[46] W&I has deemed these kiosk locations "virtual TACs" that will enable the taxpayer to have "virtual face-to-face service."[47]

In 2003, the average purchase price of a kiosk was $13,500, and it had an average annual maintenance cost of $2,800.[48] Outside of the initial purchase and the maintenance contract, kiosks have no additional costs such as rent or salaries for personnel, other than incidental costs such as the routine checking of the kiosks by Field Assistance staff. For the 2004 fiscal year, W&I had 38 kiosks in use; this was an increase over the 22 kiosks that operated during fiscal 2003.[49]

With the move to refer more taxpayers to kiosks, the kiosks have received a growing number of inquiries.[50] For the first six months of the 2004 fiscal year, the 38 kiosks received

[43] The TAC Locator on the IRS website lists the following eleven TAC offices as closed: (1) Bronx, New York, (2) Clovis, New Mexico, (3) Desoto, Texas, (4) Greenville, Mississippi, (5) Hot Springs, Arkansas, (6) Keene, New Hampshire, (7) Pine Bluff, Arkansas, (8) Queensbury, New York, (9) Quincy, Massachusetts, (10) Staten Island, New York, and (11) Warrendale, Pennsylvania. IRS Post of Duty with TAC Locator Query Results (June 25, 2004). However, it is unclear if some of these offices were merely relocated nearby.

[44] IRS Wage & Investment Division, *Strategic Assessment, Fiscal Year 2005*, 11.

[45] Appendix B, W&I CARE: Field Assistance ConOps, slide 2. Filed Field Assistance also has kiosks that are not Internet enabled and provide only general information and the ability to order forms and publications. These "alternative site" kiosks are located in storefronts and government agencies.

[46] Wage & Investment, *Strategy & Program Plan FY 2003-2004*, 9; FY 2004 Field Assistance Procedural Changes, Providing the Right Services at the Right Time in the Right Locations, 6 (Oct. 2003).

[47] Field Assistance, Talkpoints: Refocusing Our Resources.

[48] Information provided by W&I in response to an information request (Aug. 31, 2004).

[49] These kiosks are located in TACs, post offices, federal and state offices, libraries, and a mini-mall. Information provided by W&I in response to an information request (Aug. 31, 2004). For a more detailed discussion of the kiosk program, *see Taxpayers Access - Remote Interaction, infra*.

[50] At the sites of those TACs that have been replaced by kiosks, the National Taxpayer Advocate is interested to know how many visits there were to the TAC in the prior year, compared with the number of inquiries

63,078 inquiries, an increase of 113 percent over the 29,600 inquiries received on the 22 kiosks in operation during the entire 2003 fiscal year.[51] W&I has indicated that by the year 2010, it plans to replace all TACs staffed by one or two employees with virtual TACs. In the interim, the plan calls for a 25 percent replacement rate by 2006 and 50 percent by 2008.[52]

Moreover, Field Assistance employees are encouraged to redirect return preparation, tax assistance and access to forms and publications to self-service mechanisms and SPEC partners.[53] This initiative needs to be monitored to determine if it places an undue burden on those taxpayers who rely on face-to-face interaction.[54]

IRS COMMENTS

The IRS continually strives to balance customer service and compliance in the Taxpayer Assistance Centers (TAC) while attempting to meet the needs of a wide-ranging taxpayer population. We continue to offer traditional services for those taxpayers choosing face-to-face assistance and have begun encouraging the use of electronic services as an alternative to meet the demands of the taxpayer of the future. We have also expanded inventory driven collection work focusing on a non-compliant segment of the population in support of one of IRS's overarching strategic goals – to enhance enforcement of the tax law.

In FY 2004, Field Assistance (FA), operated 408 TACs nationwide, increased the number of self-help Kiosks to 38 units in 20 states, and expanded service options to the taxpayer during the filing season by offering service delivery in alternative locations such as post offices, Federal and state offices, libraries, and a mini-mall. We served 7,692,242 taxpayers in the TACs, prepared 477,000 tax returns and attained a customer satisfaction rate of 89 percent. The IRS also provides return preparation service through the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites which are significantly less costly to operate than a TAC as they are staffed by volunteers. In FY 2004, these sites increased assistance to 73,790,000 customers in 13,834 locations and prepared 1.9 million tax returns.

The customer service delivery enhancements in FA are driven by the vision laid out in FA's Concept of Operations (ConOps). To gain a clear understanding of FA's vision to *enhance* customer service, the ConOps must be considered in its entirety.

received at the kiosk. If the number of kiosk visits is lower, is anyone following up to see what has happened to those taxpayers that are no longer coming in for assistance?

[51] Information provided by W&I in response to an information request (Aug. 31, 2004).

[52] W&I CARE, *Field Assistance ConOps*, Appendix B, slide 8.

[53] Field Assistance, *Talkpoints: Refocusing Our Resources.*

[54] Currently, W&I does not have any customer satisfaction information on the use of kiosks and the services they provide.

We continue to emphasize improvement of customer service by:

- Efficiently delivering the right services;
- Expanding the scope of tax law topics;
- Encouraging taxpayer self-sufficiency;
- Balancing customer service and compliance; and
- Temporarily closing small offices only as necessary to address staffing shortages.

Efficiently Delivering the Right Services

We disagree with the statement that the TACs are "… shifting away from information and filing assistance toward the traditional compliance roles of examination and tax collection." We are focusing on delivering services that cannot be provided more efficiently within the IRS as well as providing customers with the option to choose more efficient, user-friendly electronic service delivery. We are making time and resources available to resolve the myriad account issues facing taxpayers. We recognize that service must be provided to those who do not or cannot use the electronic options while working toward the longer term vision of providing a high quality level of balanced services.

At present, FA is gaining access to the Automated Underreporter (AUR), Substitute for Return (SFR), and correspondence examination systems through Desktop Integration. These systems generate many notices to taxpayers who seek our assistance. If a taxpayer receives a notice from these systems and needs assistance, FA will be able to help them. This is an assistance role, not a traditional compliance role. By achieving the benefits of Desktop Integration, FA will finally be in a position to better assist taxpayers receiving virtually any IRS notice.

Enhancing the provision of electronic services does not necessarily decrease the level of pre-filing services. To the contrary, since large numbers of taxpayers will use the electronic services, our more costly face-to-face services can be directed to assisting more complex account and other issues that cannot be effectively handled in an electronic environment. Footnote (1) of the TAS report references our October, 2003 ConOps which implied that face to face assistance was going to be eliminated. It should be noted that in June, 2004 the ConOps was revised to make it clear that when an electronic self-help option is not available or cannot be successfully utilized, face to face assistance will continue to be available in a TAC.

The taxpaying public who responded to the 2002 and 2003 surveys had no opportunity to access the enhanced electronic services we envision. A clear example of the positive trend in survey results is the widely embraced use of the electronic "Where's My Refund?" option.

Expanding the Scope of Tax Law Topics

The NTA cites a new initiative to eliminate assistance to taxpayers with out-of-scope tax law questions at all TAC locations and asserts that these customers will be given the Customer Account Services (CAS) toll-free number to contact for assistance. This is not correct. The TAC employee is the only authorized personnel to initiate contact with CAS using the designated toll-free number. The TAC employee must ensure the issue has been resolved or prepare a written referral, once the CAS contact is completed. We did not at any time include the direction that TAC employees simply provide the taxpayer the number for the CAS line in lieu of service.

The procedure to resolve taxpayer issues varies based on the subject. For example, access to the CAS Automatic Collection System (ACS) support line is no longer needed in our TACs because we have implemented direct access to ACS in TACs across the country. If an employee with access to ACS (or with advanced account training) is not available, a referral is prepared for either internal or external resolution.

Out-of-scope assistance has not been eliminated nor is it defined as issues deemed too complicated to be answered at a TAC. The limitation in scope is directly related to our efforts to increase accuracy and ensure adequate training is provided, not complexity. As our accuracy increases and our employees' experience levels increase, we are adding topics that were previously removed due to accuracy concerns. We do not expect to achieve unlimited scope of services, but additional issues and/or services will be provided as we can support them. Questions that are out of scope are covered under our referral procedures.

Small business taxpayers are not being turned away from TACs. Although return preparation services are not available, other services such as account issues and delinquency notices are available to small business taxpayers.

ENCOURAGING TAXPAYER SELF-SUFFICIENCY

Return preparation assistance – The NTA contends that TACs are significantly limiting the availability of courtesy, need-based return preparation appointments available to lower-income taxpayers. The IRS made a conscious decision to reduce return preparation assistance in the TACs by encouraging taxpayers to use alternate methods to file returns including VITA, and "Free File" which is offered online through the IRS website. In FY 2004 the TACs prepared 190,000 fewer returns than the prior year while 330,000 more returns over the prior year were prepared by VITA.

We instituted screening of tax return preparation requests to reduce taxpayer burden and wait time, and to enhance service. Prior experience had revealed that without proper up front screening, taxpayers could wait in line an extended period of time only to learn that they did not qualify for courtesy based return preparation services and/or did not have all the necessary documentation available to complete the return. The screening process alleviates those problems by verifying the income level, issues, and availability of all necessary documentation up front.

We implemented return preparation by appointment to reduce the crowding and long waits in our TACs, and to better control workflow. The reason for the limitation of five days in advance for appointments was due to our prior experience that taxpayers were highly unlikely to return for an appointment more than five days in the future. Longer term scheduling contributed to high no-show rates and reduced productivity. It must also be noted that the move toward appointments and crowd control was driven by our desire to enhance customer service delivery within the realities of available resources while offering alternatives to all customers. However, the fact remains that without the previously detailed-in compliance support, we could not possibly prepare the same volume of returns during filing season as in prior years with significant compliance resources. We believe the result is an overall benefit to the organization with little detriment to our customers.

Transcripts – The TAS report notes that TACs no longer provide transcripts for *non-tax related matters*. The demand for this service in some locations prevented our employees from being able to serve taxpayers with *tax problems*, which is our primary objective. The IRS Campuses include a unit (the Transcript Delivery System (TDS)) dedicated to the generation of transcripts and provides the service in a high volume, cost efficient manner. The TACs use of the term "extreme hardship" reference applies *only* to requests for *non-tax related needs* and will continue to provide requests for transcripts meeting this criterion.

Taxpayers or practitioners coming into our TACs needing transcript information to resolve tax issues are serviced as in the past. We will also continue efforts to provide easier direct access to such information for tax or non-tax purposes, as has been initially implemented in the TDS.

The Treasury Inspector General for Tax Administration (TIGTA) is currently auditing FA's service delivery process. They also are using the ConOps as the starting point. Their approach includes interviews with FA leadership, visiting TACs, observing service delivery and interviewing customers. The TIGTA's feedback to date is complimentary as it relates to the transcript delivery changes following a phased-in approach over several months. The customers stated they were pleased with the reasonable alternatives offered and the fact that it frees up time for customers needing assistance with more complex issues.

Balancing Customer Service and Compliance

The IRS strategic objective as outlined in our *Strategic Plan 2005-2009* states that service and enforcement are equally important priorities, as reflected in our guiding principle – Service Plus Enforcement Equals Compliance. Our efforts are directed to achieving that critical balance which cannot and should not exclude supporting compliance.

The statement that our operational priority is to reinstate examination and collection activities at TACs and move away from pre-filing activities is incorrect. As previously noted, pre-filing activities represent a broad range of services, not limited to return preparation. The scope of pre-filing service offered in TACs (resolution of account issues that prevent processing of returns, offsetting of credits, and other notice issues) pave the way for accurate filing in the following year. We have no indication that this trend will discourage taxpayers from visiting TACs for assistance.

The resources directed to supporting compliance and collection efforts in TACs relative to pre-filing are very small. For example, in FY 2004, only 81,765 hours (0.04 percent of our total direct hours) were devoted to collection case work.

Temporarily Closing Small Offices Only as Necessary to Address Staffing Shortages

Field Assistance has made no permanent TAC office closures during FY 2004. The reference cited in the report regarding TAC Locator information as of June 25, 2004 relates to office relocations and temporary or part-time closures due to staffing shortages.

- The Bronx, NY TAC was relocated to a new office, and the public needed to be advised not to go to the prior site.
- Queensbury, NY, Quincy, MA, and Keene, NH re-opened after a temporary closure due to lack of staffing. However, Quincy is less than 10 miles from another TAC.
- Staten Island has only a seasonal employee who is temporarily in non-work status, but is expected to reopen for filing season; however, two other TACs are each within 15 miles.
- Clovis, NM has no remaining staff, but recruitment efforts have been, and remain, ongoing.
- Warrendale, PA has no remaining staff and we have been unable to hire, but the office is within less than 30 miles of TACs in both Wheeling, WV and Pittsburg, PA.
- Desoto, TX, Greenville, MS, Pine Bluff and Hot Springs, AR were small TACs closed due to lack of staffing prior to FY 2004. No complaints surfaced due to lack of service.

Unfortunately, we are sometimes unsuccessful in recruiting for vacancies in certain geographic and relatively remote areas. We have announced some positions repeatedly, with various types of advertising efforts to reach potential candidates, to no avail. Temporary closures for training, leave, or emergencies are unavoidable in small TACs with three or less full-time employees.

CONCLUSION

The IRS will continue to strive to incorporate technological changes, improve accuracy, provide better alternatives to customers, expand our scope, and better train our workforce, all in concert with the vision carefully and clearly depicted in our ConOps. Our ConOps is designed to deliver the best service possible to the widest range of customers who come through our TACs' doors day in and day out.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes that the IRS faces a number of issues as it strives to maintain a high level of service to a wide range of taxpayers with different needs, while also working to increase the number of those services that are available electronically. The National Taxpayer Advocate remains concerned, however, that the move towards the electronic availability of services will come at the expense of face-to-face access to the IRS. We will discuss these concerns in greater detail below.

The National Taxpayer Advocate is pleased that the IRS has revised its Field Assistance ConOps to make it clear that face-to-face assistance will continue to be available in instances when an electronic self-help option is not available. Moreover, the IRS is to be commended on its decision not to eliminate TAC assistance to taxpayers with out-of-scope tax law questions. The National Taxpayer Advocate was concerned that this proposal would reduce the level of service available to taxpayers who require face-to-face assistance with their questions and problem resolution. The IRS decision not to adopt this proposal at this time ensures that TACs continue to provide quality service to taxpayers who seek their assistance.[55] *Moreover, we are extremely pleased that the IRS has committed to adding new topics as training and accuracy increase. Face-to-face assistance in these topics can often help taxpayers avoid multiple pre-filing calls or post-filing problems.*

The IRS is also to be commended on its ability to offer services to taxpayers at alternative locations through its expanding kiosk program. These kiosks provide additional assistance to those taxpayers that might otherwise not interact with the IRS. As more services are offered electronically, the National Taxpayer Advocate recommends that the IRS continues to monitor taxpayer satisfaction with these services, the number and types of taxpayers utilizing them, and how taxpayers are obtaining those services that were formerly offered by TACs and are not delivered at the kiosks. In this way, the

[55] The National Taxpayer Advocate issued a Taxpayer Rights Impact Statement to Wage and Investment on October 13, 2004 regarding this matter. Taxpayer Rights Impact Statement 2004-01: TAC Out-of-Scope Questions (Oct. 13, 2004). On December 2, 2004, The Deputy Commissioner of Wage and Investment advised the NTA that W&I would not eliminate this service at this time. The IRS maintains that the planned initiative was designed to provide answers to out-of-scope questions more quickly, more accurately, and more efficiently. The National Taxpayer Advocate, along with the Taxpayer Advocacy Panel and Low Income Taxpayer Clinic representatives continue to believe that this proposed initiative reduces face-to-face service and increases the burden on taxpayers who not only need answers to their out-of-scope questions but also need assistance with the underlying issue.

IRS can determine whether it is adequately serving its customer base.[56] *In addition, the National Taxpayer Advocate encourages the IRS to look at the Social Security Administration (SSA) approach to service delivery, an organization that is also struggling with increasing the availability of the types of services accessible electronically. Currently, as SSA increases the number of services available electronically, they have continued to maintain the same level of face-to-face service. Given the overlap between the populations the IRS and SSA serves, the IRS should consider examining how SSA is able to expand its electronic services without sacrificing customers' access to face-to-face service.*

The reduction in need-based return preparation being conducted by the TACs remains a concern. While taxpayers are being encouraged to use other means, such as VITA and "Free File," there appears to be no follow up to ensure that taxpayers who were turned away from the TACs ultimately received the return preparation assistance they needed. In FY 2004, the TACs experienced a decrease in returns prepared while VITA sites experienced an increase. There is no indication that these taxpayers simply sought the assistance of VITA in lieu of going to a TAC. This could be a case of VITA volunteers doing an exceptional job in assisting one group of customers, while TAC offices turned another group of taxpayers away. The National Taxpayer Advocate strongly recommends that the IRS monitor the effect of this change in services to ensure that taxpayers who are turned away are, in fact, receiving the help they need.

The same concerns exist regarding changes to the transcript delivery system. The National Taxpayer Advocate would again recommend that the IRS monitors the effect these changes have had on taxpayers to ensure that while the changes may achieve short-term efficiencies, they create more burden for taxpayers and the IRS in the long-run. In addition, the National Taxpayer Advocate encourages the IRS to revisit its existing "extreme hardship" exception, both to ensure that it is broad enough to cover those taxpayers in serious need of assistance and to commit to additional training. The TAS will share with the IRS and the Treasury Inspector General for Tax Administration (TIGTA) what we have seen in the transcript cases that end up in our offices.

The National Taxpayer Advocate recognizes that, in certain circumstances, some smaller TAC offices may be forced to temporarily close due to lack of staffing. The IRS should continue to monitor those small sites to ensure that additional assistance remains available in the area and that taxpayers are not forced to travel long distances or endure long commutes in order to receive face-to-face assistance from the IRS. The fact that another office is available within 15 miles, as with Staten Island, is not a reason for closing when the population to be served is so great and the commute for taxpayers is significant.

In its response, the IRS emphasized that it is working to increase customer service by "effectively delivering the right services." The IRS has failed to identify the way it has determined what those "right services" are, other than the IRS' own definition of efficiency. Moreover, the IRS has stated that it has

[56] This research could involve a survey of taxpayers who use the kiosks to determine whether the services they needed were available at the kiosks; of those services that were available, how many of them did they have a need for; and how taxpayers obtained those not offered at the kiosks.

"expanded inventory driven collection work focusing on a non-compliant segment of the population..." This statement appears to be in direct conflict with a later one where the IRS disagreed with TAS' assessment that IRS is "shifting away from information and filing assistance toward the traditional compliance roles of examination and tax collection." If, as the IRS has admitted, it is expanding its collection work in TACs, and if this new work is being accomplished by the current workforce, then one can only conclude that traditional pre-filing services are being reduced. Expanding the collection services being offered with the same level of resources previously dedicated mainly to pre-filing activities can only result in a reduction of pre-filing service available to taxpayers.

The National Taxpayer Advocate agrees that it is appropriate for TACs to provide face-to-face assistance with examination and collection matters as well as account issues. She does not agree, however, that this post-filing face-to-face assistance should come at the expense of pre-filing face-to-face assistance. The IRS cannot ignore the fact that it is reducing pre-filing face-to-face assistance by simply redefining the term "pre-filing."

Moreover, while the IRS says it has no indication that the increase in compliance activities will discourage taxpayers from visiting the TACs, they also have done no testing to ensure that this is the case. Similarly, while the resources dedicated to compliance and collection activities in the TACs are small (less than one percent), they provided no estimate of what percentage of their resources would be dedicated to these activities going forward. Even a one or two percent increase would represent a significant change.

In its response, the IRS justifies reducing the availability of tax preparation in the TACs by the increased preparation service conducted through the VITA, military, and TCE programs. While the IRS may administer the VITA, military and TCE programs, the IRS does not provide these return preparation services. Community organizations and other groups run the sites and volunteers prepare the returns.[57] *While the IRS can take credit for recruiting and providing support for these VITA, military, and TCE sites, they are not a replacement for the IRS' own responsibility to assist taxpayers with their return preparation.*[58]

The current actions of the TACs are diluting the pre-filing services being offered to taxpayers. The IRS is applying the same resources to providing more services at the TACs, including a move towards compliance activities. This has resulted in fewer resources being dedicated to pure pre-filing activities in a face-to-face setting. Without conducting specific research, into what services taxpayers need in a face-to-face environment, the IRS cannot be sure that the changes they are making are not having a negative impact on the taxpayers they are serving. Nor can they be sure that the TACs are "efficiently delivering the right services," as the IRS asserts they are.

[57] The National Taxpayer Advocate recognizes that some IRS employees run VITA sites and volunteer to prepare tax returns; however this is done on the individuals' own time and is not a service provided by the IRS.

[58] This report contains a detailed discussion of the VITA Program and the problems that arise when program oversight and support roles and responsibilities are unclear. See *Problems in the Volunteer Return Preparation Program, infra.*

*We realize that, at heart, this is not an IRS issue. Congress needs to ensure that the IRS has the appropriate resources to deliver both a vigorous examination and collection strategy **and** customer service. In trying to reinvigorate and modernize its post-filing strategy, the IRS is correctly applying greater resources to those initiatives. But this refocusing comes at a cost to pre-filing services, which are vital for continued taxpayer compliance. Congress must keep this in mind when appropriating IRS funds and when exercising its oversight authority.*

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

- *Continue to monitor taxpayer satisfaction with pre-filing services, as well as the number and types of taxpayers utilizing them, to determine whether the IRS is adequately reaching its entire customer base.*
- *Examine how the Social Security Administration (SSA) is able to expand its electronic services without sacrificing customers' access to face-to-face service.*
- *Monitor the effects of the change in return preparation services at TACs to ensure that taxpayers who are turned away are receiving the help they need.*
- *Monitor the effects of the change in the transcript delivery system at TACs to ensure they have not increased burden on either taxpayers or other IRS functions.*
- *Revisit the existing "extreme hardship" exception for the transcript delivery system to ensure that it is broad enough to cover those taxpayers in serious need of assistance.*
- *Provide additional training to employees on the "extreme hardship" exception, including real life examples, so employees will know when they are presented with a request that meets the exception and take appropriate actions to assist the taxpayer.*
- *Continue to monitor those small sites that are being forced to close either permanently or temporarily and ensure that additional assistance remains available in the area and that taxpayers are not forced to travel long distances in order to receive face-to-face assistance from the IRS.*
- *Conduct research to identify what services should be offered at the TACs and kiosks and determine whether the existing service offerings at each location actually meets taxpayers' needs.*

PROBLEM

TOPIC A-3 MOST SERIOUS PROBLEM: TAXPAYER ACCESS - REMOTE INTERACTION

RESPONSIBLE OFFICIALS

Henry O. Lamar, Jr., Commissioner, Wage and Investment Division
Kevin M. Brown, Commissioner, Small Business/Self Employed Division

DEFINITION OF PROBLEM

The IRS offers customer service through face-to-face contact, or remote interaction via one of the following media: (1) telephone, (2) Internet, (3) kiosks or (4) correspondence. In an attempt to improve efficiency, the IRS encourages taxpayers to use more of its "self-assistance" customer service through remote access. However, the IRS faces significant challenges in providing taxpayers with the level and types of service that they require. Specifically, the IRS is not adequately funding various remote access applications to meet the growing taxpayer demand. As a result, taxpayers encounter the following problems:

- The demand for service through the remote applications exceeds available IRS resources.[1]
- The Automated Answering System (AAS) menu and instructions are considered one of the main sources of dissatisfaction among surveyed taxpayers.[2]
- Electronic Tax Law Assistance (ETLA), through which taxpayers can email questions to the IRS, is difficult to access because the link is no longer posted on the IRS homepage.[3]
- Poor oversight of the Kiosk Program results in kiosks providing old or inaccurate information. In addition, the IRS does not effectively inform taxpayers of kiosk locations.[4]

While taxpayers contact the agency with inquiries related to examinations and collections, this Most Serious Problem will not address inquiries related to such functions. This discussion addresses issues of general access to the IRS for taxpayers who are not responding to notices from the agency.[5]

---

[1] For example, Enterprise Snapshot, September 30, 2004 shows that 85,739,200 attempts were made to call the enterprise system. However, approximately 26 percent of the calls were unanswered or abandoned.

[2] Internal Revenue Service Customer Satisfaction Survey, Toll-Free W&I National Report Covering January through March 2004, Open Ended Insights, 21 (May 2004).

[3] The ETLA link can now be accessed by going to the official IRS website, selecting the site map, and then selecting "Help with Tax Questions."

[4] Treasury Inspector General for Tax Administration, *The Effectiveness of the Kiosk Program Cannot Be Determined*, Reference No. 2004-40-151, 1 (Aug. 2004).

[5] This discussion will not include issues related to automated collection system (ACS), the automated underreporter process (AUR), the federal payment levy program (FPLP) and the substitute for return program (SFR).

ANALYSIS OF PROBLEM

Background

Customer Account Services (CAS), which is part of the Wage & Investment (W&I) Operating Division, oversees most taxpayer interactions that are not "face-to-face." Prior to October 1, 2004, CAS had employees in both W&I and the Small Business/Self Employed (SBSE) Operating Division. Effective October 1, 2004, all CAS activities were realigned to W&I in an effort to eliminate redundancy and duplication, streamline and enhance communication, and better utilize resources while continuing to improve performance.[6]

Remote interaction with the IRS includes telephone, correspondence, and e-mail inquiries from millions of taxpayers annually.[7] The questions posed by the taxpayers cover a wide variety of issues such as tax planning, return preparation, filing, and return and payment processing.[8] Taxpayers may either contact the IRS directly through the remote application or be referred to the application by a Taxpayer Assistance Center (TAC) employee. For a more detailed discussion of the referral of taxpayers to remote applications due to the complex or "out of scope" nature of their tax law questions, see the Most Serious Problem, *Taxpayer Access – Face-to-Face Interaction.*

Taxpayer Demand

The IRS continues to direct taxpayers away from face-to-face options and toward more efficient remote applications. While there will always be a population of taxpayers requiring face-to-face assistance,[9] certain taxpayers can navigate and actually prefer the types of assistance that can be effectively delivered though remote applications.[10] A recent survey conducted by the Pew Internet & American Life Project found that 51 percent of the people tend to prefer to contact the government (whether Federal, state or local) by telephone when they need to disclose information for personal tax questions.[11]

Despite significant improvement in the Toll-Free system over the last few years, customer demand continues to outpace available resources, and the complexity of the tax law has not diminished. As a result, CAS is driven to determine how to match up each inquiry with the right source of information for the most efficient operation.

6 SB/SE Realignment Website (IRS intranet), at http://sbse.web.irs.gov/SBSE_realignment.htm.

7 IRS Wage & Investment Division, *Strategy & Program Plan FY 2004 - 2005.*

8 The Frequently Asked Questions (FAQ) link on the IRS website lists over 90 tax topics, which include such categories as itemized deductions, Social Security income, child care credit and filing requirements.

9 IRS Wage & Investment Division, *Strategic Assessment, Fiscal Year 2005*, 1.

10 FY 2003 E-Mail System Customer Satisfaction Survey Results (for September 2003, 85 percent of respondents stated they would use this E-mail service in the future).

11 Pew Internet & American Life Project, *How Americans Get in Touch with Government*, 22 (May 25, 2004).

Telephone Assistance

Access to Toll-Free telephone assistance was among the most serious problems encountered by taxpayers in the 2001 Annual Report to Congress.[12] It remains a challenge for the IRS to balance its resources with the level of service required to meet increased demand.[13] Toll-Free experienced an increase of approximately 18 percent in total call attempts from the 2003 filing season to the 2004 season. During the same period, the IRS experienced a minimal increase in primary abandons, when viewed as a percentage of total call attempts, and a significant decrease in blocked calls.[14] Moreover, the IRS has reported that the level of service (LOS)[15] for CAS Toll-Free has risen to approximately 87 percent in fiscal year (FY) 2004 from approximately 80 percent in FY 2003.[16] We commend the IRS for achieving this level of service, but problems and challenges remain.

While access to the Toll-Free service appears to be improving, the Treasury Inspector General for Tax Administration (TIGTA) has noted that the system experienced a significantly higher rate of call abandons than is considered optimum for the call center industry.[17] The IRS has no technology to determine at which point during calls the taxpayers hang up. However, the IRS plans to deploy new technology in early January 2005 which will help identify this information.[18]

Taxpayers who are able to access the system utilize the Automated Answering System (AAS) menu, a tool for directing incoming phone traffic with no initial use of human resources. Ideally, the AAS frees up customer service representatives to answer questions,

[12] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104, 9 (Rev. 12-2001).

[13] Treasury Inspector General for Tax Administration, *Taxpayers Experienced Improved Access to Toll-Free Telephone Services During the 2004 Filing Season*, Reference No.2004-30-144, 3 (Aug. 2004).

[14] A call attempt is considered a "primary abandon" if the caller hangs up before reaching an assistor queue for a CSR. "Blocked calls" occur if a circuit is unavailable or if the queue has reached a defined threshold. If a call is "blocked," the taxpayer receives either a busy signal or is told to call again. Approximately 50 million taxpayers attempted to call during the 2004 filing season compared to 42 million during the 2003 filing season. During the 2004 filing season, 6.7 million taxpayers (13.5 percent) were disconnected before reaching the queue of customer service representatives as compared to 5.4 million (12.8 percent) during the 2003 filing season, In the 2003 filing season, approximately 1.3 million calls were blocked as compared to under 800,000 in the 2004 filing season. Treasury Inspector General for Tax Administration, *Taxpayers Experienced Improved Access to Toll-Free Telephone Services During the 2004 Filing Season*, Reference No. 2004-30-144, 3-13 (Aug. 2004).

[15] CSR Level of service (LOS) measures the relative success rate of taxpayers that call for Toll-Free services seeking assistance from CSRs. CSR LOS is calculated by dividing the number of calls answered by CSRs the total call attempts of callers attempting to reach the CSR queue (Essentially, CSR LOS measures the percentage of customers who want to reach a CSR and who are successful). Total call attempts is the sum of calls answered, calls abandoned by the caller, and calls that receive a busy signal. CAS Data Dictionary, at http://joc.enterprise.irs.gov/new/josh/reports, 1.

[16] Enterprise Snapshot Report, Week Ending September 30, 2004.

[17] The optimum disconnect rate for the call center industry falls between the range of 3 and 5 percents, which is significantly less than 13.5 percent experienced by the IRS; Treasury Inspector General for Tax Administration, *Taxpayers Experienced Improved Access to Toll-Free Telephone Services During the 2004 Filing Season*, Reference No. 2004-30-144, 10 (Aug. 2004).

[18] Treasury Inspector General for Tax Administration, *Taxpayers Experienced Improved Access to Toll-Free Telephone Services During the 2004 Filing Season*, Reference No. 2004-30-144, 11 (Aug. 2004).

instead of simply identifying the topic and transferring the call to an assistor with the necessary skills.

In a 2004 W&I customer satisfaction survey on the Toll-Free service, taxpayers gave some of the lowest satisfaction ratings to items related to the AAS menu system.[19] Specifically, 40 percent of dissatisfied callers indicated they had difficulty navigating the AAS system due to the lack of appropriate menu options, the sheer number of options, or vague descriptions of the options. Eighteen percent of the dissatisfied complained that they were placed on hold for too long.[20]

Given the call volume, the National Taxpayer Advocate believes that it is reasonable for the IRS to attempt to automate many inquiries, such as refund questions. However, certain types of calls are best served by contact with a live customer service representative. Determining which questions fall into which category is a daunting challenge for the IRS, depending in part on the taxpayer's own ability to understand the choices and correctly select from the menu.

In addition to the workload analysis (e.g., the number of calls, disconnects and primary abandons), and customer satisfaction surveys, the IRS does not seem to track data and conduct analytical research to determine:

- The reasons taxpayers are calling;
- Exactly what causes taxpayers to be confused about the Toll-Free menu system; and
- The reasons taxpayers disconnect and whether they actually call back.

In a customer satisfaction survey sponsored by SB/SE, taxpayers expressed frustration with the quality of service received from the customer service representative (CSR). The survey found that 43 percent of the customers who felt their issue was not resolved by the first call actually contacted the IRS more than once about the same problem. Of those who called multiple times, 46 percent received different answers.[21] The same survey found that satisfaction with service declines as the following items increase: (1) the number of calls placed by the taxpayer about each issue, (2) the frequency of transfers and (3) the length of the call. Further, respondents to the survey understandably indicated they were less satisfied with the Toll-Free service when they received different answers to the same question on different calls.[22]

[19] Internal Revenue Service Customer Satisfaction Survey, Toll-Free W&I National Report Covering January through March 2004, Satisfaction Ratings, 13 (May 2004).

[20] Forty (40) percent of the callers dissatisfied with the AAS indicated that they had difficulty navigating the system. *Id.* Open Ended Insights, 21 (May 2004).

[21] *Id*, Report Summary, 6 (May 2004).

[22] *Id*, Satisfaction Ratings, 24-25 (May 2004).

Referral Mail

Referral mail (R-Mail) is used within the Telephone Routing Interactive System (TRIS) as a workload distribution system to automate support for tax law telephone referrals.[23] An R-Mail inquiry is generated when a taxpayer poses a tax law question which has been predetermined to be an R-Mail topic. R-Mail assistors typically have extensive knowledge of the tax law topic to which they are assigned. During the 2004 filing season, the pre-determined categories of questions referred to the R-Mail application included these wide-ranging topics:

(1) capital gains and losses,

(2) partnership and corporate taxation,

(3) depreciation and the sale of business,

(4) rental property,

(5) estate and gift taxes,

(6) international aliens, and

(7) trusts and fiduciary.[24]

R-Mail received approximately 310,000 calls in the 2004 filing season, an increase of approximately ten percent over the previous year.[25]

When a tax law question falls into a predetermined R-Mail category of topics, the taxpayer is advised that the call must be transferred to an R-Mail screener, an employee with access to the R-Mail system who will input the request for assistance. The request is logged into the system and the taxpayer is advised that an assistor will respond later. Typically, taxpayers receive responses from R-Mail assistors by phone within three business days. R-Mail assistors are required to make two attempts on two different days to reach the taxpayer by phone, and the Internal Revenue Manual (IRM) instructs those who do not reach the taxpayer to leave a voicemail message or send a "No Contact" letter.[26]

Some inherent problems with the system are:

- *The inquiry will be closed if the taxpayer is unavailable when the assistor calls.* The taxpayer will usually receive a response by phone within three business days. However, if the R-Mail assistor cannot reach the taxpayer after the required two attempts on two different days, the inquiry will be closed out and the assistor will either leave a

[23] SBSE Newsletter for employees in Compliance Area 1 and 2 and Tec Area 1, Vol. 3 Issue 1, 7 (Jan. 2004).

[24] Briefing by W&I, Accounts Management (Dec. 3, 2004); RMail Weekly Inventory Report, Data For Week Ending May 8, 2004; Email from Director of CAS Consolidations to the National Taxpayer Advocate (Aug. 12, 2004).

[25] During filing season 2003, R-Mail received approximately 281,000 calls. Briefing by W&I, Accounts Management (Dec. 3, 2004).

[26] IRM § 21.1.1.9; R-Mail Assistor Guide 2005, Automated Referral System.

voicemail message or send a "No Contact" letter. Nothing in the IRM requires the assistors to provide substantive answers to the tax law questions if they do not contact the taxpayer by phone.[27] Under such circumstances, the taxpayer has the choice of (1) contacting the IRS again, (2) finding another resource to resolve the issue or (3) just giving up.[28]

- *The R-Mail assistor may not completely answer the question in a written response.* The R-Mail assistor pulls the tax law questions from an automated menu system. An assistor who cannot reach the taxpayer by phone will provide a substantive tax law response in the "No Contact" letter if the inquiry is clear and contains enough facts to be answered in writing.[29] In these circumstances, the taxpayer does not have the opportunity to clarify the issue with the assistor before receiving the written response.[30] Although the assistor believes the query is clear and complete, there is a risk that the taxpayer will receive a written response that does not necessarily answer the taxpayer's question.

During FY 2004, the IRS conducted no surveys of taxpayer opinion on the written responses received through R-Mail. It is unclear whether the IRS tracks data to determine: (1) the number of taxpayers who receive written responses, (2) whether taxpayers were satisfied with the responses, (3) how many of those who received written responses re-contacted the IRS for additional assistance with the same issue, and (4) whether the response was accurate.

Electronic Tax Law Assistance

Electronic Tax Law Assistance (ETLA), a service provided through a link on the official IRS website, allows taxpayers or practitioners to e-mail tax law questions directly to the IRS. The link was formerly known as "Ask the IRS," but has been renamed "Help with Tax Questions." The system is designed to allow employees to pull responses from the database of pre-written answers and, thus save time researching and responding to frequently asked questions.

Taxpayers have responded favorably to ETLA, which allows them to bypass the wait and menus associated with phone inquiries. Although e-mail is not immediately interactive,

---

[27] IRM 21.1.1.9(5).

[28] The R-mail program directly contributes to the volume of calls received by the toll-free sites which directly affects the levels of service and access the IRS is able to provide The IRS customer satisfaction surveys have consistently documented the direct correlation between the number of calls to the IRS and the level of satisfaction. IRS Customer Satisfaction Survey Toll-Free SB/SE National Report covering January through March 2004, page 21, states that 43 percent of customers are calling more than once about the same issue, and that taxpayers that make multiple calls rate their overall level of satisfaction lower than those taxpayers that have their issues resolved more quickly.

[29] R-Mail Assistor Guide 2005, Automated Referral System.

[30] R-Mail Training FY-2004 Assistor Excellence Training Complete Response Instructor Guide, page 4, notes that failure to ensure that the taxpayers understand the response and did not have follow-up questions is a common enough error to require coverage in training.

accessibility to the IRS is superior with respect to the phone.[31] Approximately 90 percent of customer satisfaction survey respondents stated they would use ETLA in the future.[32] While a recent study conducted by the IRS Oversight Board found the Toll-Free service to be the main service taxpayers would use for assistance with a tax issue,[33] another recent study by Pew Internet & American Life Project also found a steady upward trend in the use of the Internet to contact Federal, state and local government agencies, as Internet users tend to use e-government services to research general information and look up documents.[34]

Despite the survey findings, CAS has never favored promoting, "Ask the IRS," because the ETLA program poses a significant demand on the organization's resources. Between typing responses and attempting to cover many areas of tax law,[35] representatives generally process two inquiries per hour.[36] There is a further concern that a portion of the tax law questions posed on ETLA would never be asked at all if the program did not exist.[37]

During FY 2004, the IRS was ill-equipped to deal with an unexpected increase in demand for ETLA. For the 2004 filing season, the IRS only anticipated a ten percent increase in ETLA volume over the 2003 season.[38] However, ETLA receipts surged by approximately 36 percent during January 2004.[39] During the first five weeks of calendar year 2004, ETLA receipts numbered approximately 44,000 as compared to approximately 34,000 for the same period in 2003. Thus, the IRS received approximately 6,000 more ETLA questions than anticipated.[40]

In response to the overwhelming demand for ETLA, W&I took steps to mitigate the problem. Despite clear evidence that taxpayers viewed ETLA as a valuable tool for obtaining

[31] FY 2003 E-Mail Customer Satisfaction Survey, Results monthly reports and Project 2.07, ii (April 2001), report on the Benefits of "Ask the IRS" Electronic Tax Law Assistance, 33.

[32] FY 2003 E-Mail System Customer Satisfaction Survey, Results for each month from November 2002 through September 2003.

[33] IRS Oversight Board, *Annual Report 2004*, Appendix 2: Taxpayer Attitude Survey 2003, vi-vii.

[34] Pew Internet & American Life Project, *How Americans Get in Touch with Government*, 20-21 (May 25, 2004).

[35] ETLA currently precludes the dialogue that allows a telephone representative to narrow the question and establish specific details to formulate a targeted answer.

[36] Office of Customer Account Services (March 31, 2004); IRS Enterprise ETLA – Internet E-mail Data Warehouse, FY 2003 ETLA Plan1 (700-60100).

[37] A recent survey found that the "Internet has an additive effect on the overall frequency of contacting government." The study looked at how people contact all levels of government, whether Federal, state or local. Further, the study found that the frequency of Internet contact may be attributable to people expressing their opinions. Pew Internet & American Life Project, *How Americans Get in Touch with Government*, 26 (May 25, 2004).

[38] W&I Strategy and Program Plan 2001-2003, 98 (Forecasts ETLA receipts at 223,877 for FY 2003); FY 2004 Customer Account Services Work Plan, Planning Assumptions, 10.

[39] Analysis of ETLA Weekly Inventory Reports: Enterprise Receipts (less deletes) for Week 5, 2003 = 10,907; 2004 = 14,834.

[40] The five weeks actually started Dec. 28, 2003. W&I expected a ten percent increase in the ETLA receipts over the 2003 filing season numbers which would have been approximately 38,000 receipts. FY 2004 Customer Account Services Work Plan, Planning Assumptions, 10.

tax assistance, W&I moved the ETLA link from its prominent location on the IRS homepage to the Site Map for the website sometime during the sixth week of 2004. Subsequently, total ETLA volume for filing season 2004 decreased significantly from the previous year.[41] ETLA receipts for weeks 6 through 10 totaled approximately 46,000 for FY 2003 and approximately 16,000 for FY 2004, a decline of approximately 65 percent.[42] This time period begins in the month of February, which corresponds to increased levels of attempts to contact the IRS. It appears that when deciding how to handle the increase in ETLA receipts, the IRS resolved its dilemma without fully determining the adverse impact its actions would have on taxpayers.

Through the following quote in the IRS Strategic Plan for 2005-2009, the agency indicated that it recognizes the importance of providing taxpayer services through the Internet.[43]

> The internet has revolutionized our ability to serve taxpayers and their representatives. We have used the internet to meet taxpayer demands for quick access, user-friendly tools and better service, and we will continue to use the internet to reduce burden. In the future we envision the public will be able to conduct the vast majority of tax interactions electronically. We will continue to improve electronic filing, payment and communication services via the internet.

However, despite the overwhelming demand for the ETLA program in FY 2004, the IRS has decided to allocate its resources in a way that may not sufficiently support the demand for FY 2005.[44] While making the ETLA link less visible keeps the volume of questions down, it does not provide adequate customer assistance to taxpayers in need. As the IRS strives to direct resources away from face-to-face contact and toward remote interaction, it needs to analyze ETLA and provide an accessible product geared toward the needs of taxpayers.

The National Taxpayer Advocate believes that the program should be developed and implemented as originally intended: as an Internet-based self-help mechanism. Based on artificial intelligence technology, the system was initially created to collect examples of taxpayer questions and store the prepared answers in a searchable database, which would be continually monitored for tax law updates and used to address future questions. The proposed user-friendly interface would recognize common tax law questions posed in nat-

[41] Analysis of ETLA Weekly Inventory Reports: Total Filing Season Receipts through week 13: 2003 = 104,906: 2004 = 64,274.

[42] Analysis of ETLA Weekly Inventory Reports.

[43] IRS, *Strategic Plan 2005 – 2009*, 8.

[44] SBSE/CAS/AM Program Impacts for FY05 Initial WP/Assumption Memo (Rev. June 2, 2004) states the FY 2005 ETLA Projection is based on volumes received during 1st Planning Period to March of FY 2005. FY 2003 data was used from March through September. A five percent growth factor was applied for FY 2005.

ural language searches and retrieve the appropriate response without human intervention. The natural language interface would also have the capability to search IRS publications covering a variety of tax law topics. Further, the interactive system would prompt the user to answer targeted questions in order to tailor the response to each taxpayer's specific facts and circumstances. More complex questions would still require a more specific and detailed human response.[45] If the system was implemented and funded properly as a user-friendly self-help desk, ETLA would provide an efficient service to taxpayers and potentially reduce phone calls, freeing up assistors for face-to-face interaction or more detailed and accurate remote interaction.

Kiosk Program

The IRS introduced the Kiosk program in 1998 in an effort to broaden self-assistance customer service. Since 1998, the IRS has spent over $650,000 to purchase, update and maintain approximately 38 kiosks in Taxpayer Assistance Centers (TACs), post offices, federal and state government buildings, libraries and malls in 20 states. The kiosks provide taxpayers with an alternative method of obtaining Federal and state tax forms as well as answers to frequently asked questions.[46]

In a recent audit, the Treasury Inspector General for Tax Administration (TIGTA) found the kiosk program lacks sufficient internal controls and management oversight to determine its effectiveness. TIGTA also reported that the information provided on the kiosks was not current or accurate. Further, the IRS does not monitor existing and future kiosk locations to determine the optimal placement. In its response to TIGTA, the IRS committed to addressing these issues.[47]

Despite the fact that the IRS is attempting to divert taxpayers from face-to-face to self-assistance customer service, TIGTA also found the IRS lacks adequate means of educating taxpayers about the benefits or locations of kiosks. The IRS only informs taxpayers of the kiosk option on the official IRS website. However, most taxpayers using the site would not need a kiosk, because the services offered by kiosks are also provided on the Internet. Further, it is very likely that someone needing to use a kiosk cannot access or navigate the IRS website. In response to the TIGTA audit report, the IRS committed to develop a more meaningful process to educate taxpayers.[48]

Remote Access by International Taxpayers

Taxpayers who live overseas rely heavily on remote assistance. To obtain aid, these taxpayers must either walk into IRS sites at U.S. embassies or deal with the IRS through the

[45] IRS, Office of Artificial Intelligence Lab, currently the Office of Intelligent Business Solutions (April 16, 1998).

[46] Treasury Inspector General for Tax Administration, *The Effectiveness of the Kiosk Program Cannot Be Determined*, Reference No. 2004-40-151, 1 (Aug. 2004).

[47] *Id.* at 4-7 (Aug. 2004).

[48] *Id.* at 5-7 (Aug. 2004).

Internet or telephone. Unfortunately, according to IRS plans for FY 2005, international assistance is being reduced as follows:

- International hours of operation will be reduced by three hours.[49]
- The number of foreign assistance centers providing full face-to-face assistance decreased by approximately 50 percent during FY 2004.[50]

Due to the decrease in the availability of face-to-face assistance abroad, many international taxpayers without the resources to hire tax professionals will be forced to either call a non-toll-free IRS telephone line available to international taxpayers, submit questions through ETLA, or use self-assistance methods, such as researching IRS publications available on the Internet.[51]

For a discussion of the problems associated with the processing of ITIN applications, see the Most Serious Problem *Processing ITIN Applications and Amended Related Federal Income Tax Returns.*

IRS COMMENTS

The IRS remains committed to providing top quality service to our customers, and we agree that continuous improvement of our remote interaction service vehicles is an important component of this goal. As the Taxpayer Advocate recognizes, we have made significant improvements in the access to our primary remote interaction vehicle, Toll-Free Telephone Service, and we continue to explore ways to meet customer needs in the most efficient and cost effective way.

Telephone Assistance

We agree that there is still room for improvement in delivery of toll free service and challenges remain. Although significant strides have been made in improving the customer experience over the last three years, we recognize that improvement of scripts and menus, which direct the taxpayer to skilled customer service representatives (CSR), is needed. Taxpayers abandon (hang up) while navigating these scripts in higher numbers than desired.

A barrier to our ability to reduce the number of primary abandons has been a lack of available data about where in the scripts customers abandon. We are implementing Internet Service Node (ISN), explained below, to overcome this problem.

[49] Effective FY 2005, the Philadelphia Accounts Management Center (PAMC) will provide access to international assistance between the hours of 05:00am and 10:00am CT (plus queue). The FY 2004 PAMC hours were 05:00 AM to 1:00 PM.

[50] As of November 4, 2004, the IRS official website (http://www.irs.gov/localcontacts) stated that the IRS had full-time permanent staff in three U.S. embassies and consulates (Berlin, London and Paris). Further, http://lmsb.irs.gov states that, effective July 2, 2004, the Tokyo and Rome foreign assistance centers have closed. The Mexico City foreign assistance center closed effective September 30, 2003. The closure of these three sites reduced the number of available international sites by 50 percent.

[51] SBSE/CAS/AM Program Impacts for FY05 Initial WP/Assumption Memo (Rev. June 2, 2004).

The report references both the W&I and SB/SE Toll-Free Customer Satisfaction Survey Reports for the period January - March 2004. While we continue to strive for 100 percent satisfaction, it is important to note that the overall customer satisfaction rating reflected in both surveys is 94 percent. The Customer Survey results cited in this report relate only to the six percent of customers surveyed who indicated they were not satisfied with the service they received. Although the data is generally correct, it may be misleading without the perspective of the overall results.

For example, page 6 states "…40 percent of dissatisfied callers indicated that they had difficulty navigating through the AAS system due to the lack of appropriate menu options, the sheer number of options or the vague descriptions of the menu options." However, of all customers who completed the survey, only 2.4 percent indicated they were dissatisfied with these issues (40 percent of the 6 percent dissatisfied). Although continued improvement in this area is needed, the analysis and actions described below appear to have produced positive results. The January - March 2004 Survey reflects a statistically significant improvement from the previous period (October - December 2003) moving from 4.37 to 4.47 (on a 5 point scale) for "Ease of Understanding AAS Menu and Instructions" and 4.15 to 4.36 for "Finding Appropriate Menu Choice."

Regarding SB/SE taxpayers that expressed frustrations with the quality of service received from the CSR, the report fails to mention that the overall satisfaction rating for this period was 94 percent. On a 5-point scale, the average rating was 4.65. This represents a statistically significant increase from 4.55 for the parallel period the previous year (January-March 2003), indicating that the customer's perceptions regarding Toll-Free service have improved over time. We recognize that improvement is still needed to increase the percentage of callers who believe their issues are resolved on the first call and to ensure that they get the same answer if they do call more than once.

During FY 2003, the IRS implemented a series of "specialized" toll free numbers. This initiative allowed segmentation prior to the customer going through streamlined scripts at the network. The result was a significant reduction in the primary abandon rate of 6.3 percentage points from 19.1 percent (FY 2002) to 12.8 percent (FY 2003).

In addition, we conduct ongoing analysis to evaluate the following issues:

- The reason taxpayers are calling;
- Exactly what causes taxpayers to be confused about the Toll-Free menu system; and
- The reason taxpayers disconnect and whether they actually call back.

The IRS is in the process of upgrading the infrastructure used to screen customers for the FY 2005 filing season. Menus will be moved from the AT&T prompter to Internet Service Node (ISN). This upgrade will provide the capability of determining the exact point at which customers are abandoning, which is a necessary starting point in determining which portion of the menus need to be changed to better meet customer needs. The ISN infrastructure will also decrease the cycle time it takes to get changes implemented.

With the ability to identify problem areas and make the changes more quickly, the IRS expects to be able to make data-driven decisions about script changes, aimed at reducing the primary abandon rate. The IRS also plans to increase the use of Usability Testing for any planned changes.

Referral Mail (R-Mail)

R-Mail is a workload distribution process used to maximize the significant number of resources needed to respond to tax law questions during the filing season. Topics are included in the program, not because they are "out of scope" for CSRs but, instead, due to the sheer volume of questions in these categories.

Accounts Management is unable to maintain the number of highly skilled staff needed to answer the significant increase in technical tax law questions during the short (three month) filing season. Prior to implementation of enterprise call processing and call site specialization, Compliance employees would be detailed to local call sites during the filing season to supplement the call site staff and assist in answering technical tax law questions in these categories. The R-Mail system allows us to more efficiently utilize TEC and Compliance resources regardless of their location.

Electronic Tax Law Assistance (ETLA)

ETLA was not designed nor envisioned to be a primary customer service delivery channel, and when compared to our other service options, has served a relatively limited number of customers. As the Taxpayer Advocate acknowledges in her report, toll-free service is the method preferred by the majority of taxpayers seeking assistance with a tax issue. Telephone assistance provides several benefits to the IRS and our customers that are not found in an e-mail based system. We believe that telephone service is preferable because:

- Access to a telephone is readily available to virtually all socio-economic strata of our diverse customer base.
- It allows active two-way communication between the customer and our CSR allowing clarification of the issues and facts to arrive at a correct answer. Due to systemic limitations, ETLA does not allow for interactive communication between the customer and CSR.
- The IRS can match customer questions to CSR skill levels and dynamically route the call to an available CSR.
- Customer calls for tax law assistance can be answered more efficiently than responding to tax law questions submitted by e-mail.

During the past five years we have invested heavily in improving virtually every aspect of our toll-free service. Each year we are making substantial progress toward achieving our goal of improving telephone service. Allocating appropriate levels of staffing to provide e-mail tax law assistance to a large volume of e-mail inquiries would diminish the staff available to provide customer-preferred telephone service.

We will continue our efforts to effectively use the Internet as a tool to deliver information and broad market-based interactive self-service assistance options. However, while web features such as Frequently Asked Questions, Tax Trails, and access to forms and publications provide information to our customers in a cost effective manner, with current technology, ETLA is not a purely self-service application, but, as mentioned above, competes for limited resources with our toll-free service. Therefore, we do not plan to increase the prominence of the ETLA feature for the 2005 filing season, except for overseas customers.

We are continuing to explore ways to improve the efficiency and effectiveness of ETLA. We have recently initiated a project which will evaluate the applicability of Natural Language search engine technology to our business. We hope that this technology can improve the accuracy of self-service queries and allow the kind of user-friendly, interactive interface for ETLA that the Taxpayer Advocate references in her report. Implementation of such technology would be dependent on funding priorities, and therefore would most likely not be realized until FY 2007, at the earliest.

Kiosk Program

We are in the process of reassessing our long-term strategy for kiosks and other initiatives designed to provide taxpayers with self-service delivery methods. When completed, our strategy will identify the long term goals, procedures, and measures needed to ensure that taxpayers not requiring face-to-face assistance have alternative self-service tools.

We also plan to develop guidelines and strategies to improve oversight of the program, and to develop a process to educate taxpayers on the benefits of the Kiosk Program, including the locations of kiosks.

To address TIGTA's findings, we have committed to implementing the corrective actions detailed below:

- Internal Control and Management Oversight
- Develop a standardized operational review guide for the Kiosk Program to ensure consistency in the review process.
- Develop guidelines for analyzing kiosk information to identify trends, issues, and areas needing improvement.

- Develop a Kiosk Checklist requiring field personnel to certify annually that the information on the kiosks is current and accurate, and the kiosks are operating as intended.
- Kiosk Usage and Customer Satisfaction
  - Develop guidelines for analyzing usage reports and other information on the kiosks to identify trends, issues, and areas needing improvement.
  - Install the newly developed Customer Satisfaction Survey on all kiosks. We will use the survey results to determine taxpayer satisfaction with the services received and to determine whether additional services or information is needed to help taxpayers meet their tax obligations.
- Optimal Location of Kiosks. Use the Service Delivery Model (SDM) to determine the optimal location of kiosks. The SDM provides data on where our services are located in relation to where taxpayers live. We use the SDM to determine if we are meeting our goal of providing service to 85 percent of taxpayers within a 45-minute commute of a Taxpayer Assistance Center or alternate delivery vehicle. Alternate delivery vehicles include kiosks, mobile units, and alternate sites such as shopping malls and community centers.
- Taxpayer Education on the Benefits and Locations of Kiosks
- Initiate discussions with the Department of Housing and Urban Development (HUD) to determine the feasibility of using HUD's kiosks to expand access to IRS information.
- Develop a communication plan to educate taxpayers on the benefits and locations of kiosks. We believe this effort will be very beneficial in reaching taxpayers needing the services offered on kiosks.
- Involve our Multilingual Initiative (MLI) Project Office in an effort to ensure information on the kiosks meets the needs of taxpayers who do not speak English. We will use the information maintained by the MLI Project Office to identify languages, other than Spanish, needed on the kiosks.

Remote Access by International Taxpayers

IRS continuously seeks to find a balance between high-quality service delivery and efficient use of resources. The Taxpayer Advocate is correct that we have had to make adjustments to how, where and when we offer services to International Taxpayers, to ensure a more focused use of our resources.

We have eliminated telephone service between 10:00 pm CT and 1:00 am CT for International customers. This decision was based on the very small customer demand for service during these three hours, representing only 1.4 percent of the daily demand, and averaging less than four calls per hour.

Although it is true that the number of foreign assistance centers providing full face-to-face assistance decreased during FY 2004, the majority of contacts from overseas customers are generally via telephone and correspondence, rather than face-to-face walk-ins. Taxpayers are directed to call the Philadelphia International call center or send their correspondence there. We also continue to conduct filing season tax assistance tours and plan to visit 43 cities around the world during the FY 2005 filing season. During the FY 2004 filing season, over 2000 walk-in customers were assisted via this service, and 1,184 tax returns were prepared.

We are planning to improve the placement of the web site link to ETLA for International customers, to make this service more easily accessible to this specialized customer group.

TAXPAYER ADVOCATE SERVICE COMMENTS

We commend the IRS for implementing various initiatives to improve the quality and accessibility of self-help applications. To maximize the cost savings associated with each of the remote applications, the IRS needs to ensure that they are properly designed. Increasing the efficiency and quality of customer service provided by each application would have the ultimate effect of freeing up resources which the National Taxpayer Advocate believes should be allocated to further improve customer service.

The IRS points out that it received a 94 percent customer satisfaction rating. This is remarkable achievement and we applaud the IRS for its success. Nevertheless, based on the IRS's numbers, 2.4 percent of the callers expressed dissatisfaction with the menu options. While this percentage might appear insignificant, considering that there were over 70 million call attempts into the Toll-Free system during FY 2004, 2.4 percent amounts to a significant number of dissatisfied callers.[52]

The implementation of the Internet Service Node (ISN) will provide extremely useful data to determine exactly when Toll-Free customers are hanging up and we commend the IRS for doing this. In addition to the ISN, the IRS should test its menus- through cognitive and behavioral testing- before any future menu redesigns are implemented. This type of analytic research would help the IRS understand the reasons customers hang up and, thus, avoid future problems.

While Toll-Free assistance may be the primary method to seek assistance, the IRS must acknowledge taxpayers' favorable response to ETLA. The fact that receipts surged once the link was prominently located on the website indicates that taxpayers clearly demand this remote access application. Although each application must compete for limited resources and ETLA, as currently designed, is not as cost-effective as other applications, the IRS should attempt to meet the demand for ETLA by

[52] Enterprise Snapshot, Week Ending September 30, 2004. Applying the 2.4 percent figure to the 70,877,058 net call attempts results in approximately 1.7 mil. However, it must be noted that this number does not necessarily translate to the number of dissatisfied callers, because some callers make several attempts before they receive the information they need. Further, although the 2.4 percent figure is derived from a customer satisfaction survey conducted between January and March 2004, we are applying the percentage to the entire fiscal year to illustrate the potential number of callers who had a problem with menu options during the entire fiscal year.

making it more accessible to both domestic and international taxpayers.[53] *Rather than merely devoting more resources to the application, the IRS should continue to explore ways to improve the design of ETLA to make it a more cost-effective self-help mechanism. We are optimistic that the IRS's newly initiated program to make ETLA more interactive and user-friendly will eventually result in a more efficient program that meets taxpayer demand.*

Finally, the planned Kiosk program initiatives should greatly improve the access and quality of the customer service provided through this remote application. As previously discussed, it is important that the IRS educate taxpayers regarding the benefits and locations of kiosks through media other than the Internet. Nonetheless, the IRS indicated that kiosks are considered "alternate delivery vehicles" which count toward meeting the goal to provide service to 85 percent of taxpayers within a 45-minute commute. The National Taxpayer Advocate does not believe that kiosks are a suitable replacement for the face-to-face service taxpayers receive at a Taxpayer Assistance Center, mobile unit or alternate site.

RECOMMENDATIONS

In addition to the initiatives described by the IRS, the National Taxpayer Advocate recommendations include:

- *The IRS must educate taxpayers on the advantages and short-comings of using remote assistance. This involves informing taxpayers of the services available to meet different needs as well as the benefits and limitations associated with each application. This information will prepare taxpayers as to what they should expect and prevent future frustrations.*[54]
- *W&I should conduct a real-time study during filing season that would ask randomly selected Toll-Free customers whether they had called previously regarding the same issue. If so, the survey should question why the customers felt the need to call again (i.e., clarification, confusion, partial answer, follow-up question, etc.) and whether they received consistent advice during the multiple calls. The findings would facilitate strategic planning to reduce the unnecessary burden on the system by eliminating the customers' perceived need to make multiple calls. For example, the findings may assist the IRS in determining how to address these issues through employee training or changes to the Probe and Response Guide.*
- *Rather than merely conducting customer satisfaction surveys, the IRS needs to take a more proactive approach to determining the exact obstacles taxpayers face while they navigate through the Toll-Free system. This research could take the form of a learning lab, which would test different approaches and scenarios on focus groups, comprised of a representative sample of individuals, to understand how they navigate through the system and the optimal way to design the system to make the directions and menu options more user-friendly.*

[53] See Government Accountability Office, *Tax Administration: IRS Improved Performance in the 2004 Filing Season, But Better Data on the Quality of Some Services Are Needed*, GAO-05-67, 24 (Nov. 2004).

[54] For example, the IRS could publish a simple paper brochure titled "Getting Help from the IRS," which explains the various customer service options in different languages.

- *The IRS should conduct customer satisfaction surveys of those taxpayers who receive written responses through R-Mail. The respondents would be asked to rate their experience and whether the IRS response was timely, accurate, and completely addressed the question. Further, respondents should indicate whether they needed to re-contact the IRS for additional assistance on the same issue.*
- *The IRS should explore developing ETLA as it was originally intended - a more cost-effective self-help application. By utilizing artificial intelligence, taxpayers could retrieve answers to common questions without human interaction so that resources would be available for more complicated questions.*
- *The IRS should review the experience of Federal, state and local organizations, as well as organizations in the private sector, which utilize kiosks as a service delivery option. Did the kiosks replace other types of services? After a number of years in operation, how did customers rate the services provided at kiosks?*

PROBLEM

TOPIC A-4 MOST SERIOUS PROBLEM: ACCURACY OF TAX LAW AND ACCOUNTS ASSISTANCE

RESPONSIBLE OFFICIAL

Henry O. Lamar, Jr., Commissioner, Wage and Investment Division

DEFINITION OF THE PROBLEM

The complexity of the tax law leads many taxpayers to seek IRS assistance in dealing with their tax obligations. A 2003 survey conducted by the IRS Oversight Board found that taxpayers heavily rely upon IRS services for their tax information and advice.[1]

As the tax law increases in complexity, the IRS faces even greater challenges in providing accurate, specific, and helpful answers to taxpayers' questions. The IRS is not meeting its own goals for the accuracy of tax law responses provided to taxpayers by the Toll-Free Telephone Assistance service (Toll-Free).[2] Despite initiatives taken by the Wage and Investment Operating Division (W&I), tax law accuracy rates have continued to slide from fiscal year (FY) 2002 through FY 2004.[3]

The accuracy rates for both the Toll-Free and the Taxpayer Assistance Centers have been the subject of numerous recent audits by the Treasury Inspector General for Tax Administration (TIGTA). Two TIGTA audits on the accuracy of Toll-Free accounts and tax law information resulted in even lower accuracy rates than reported by the IRS.[4] The IRS strongly disagreed with the findings of the TIGTA audit on the accuracy of Toll-Free account calls.[5] In a separate audit, TIGTA found that while accuracy rates appear to have improved in the IRS's Taxpayer Assistance Centers (TACs), TAC employees still experience problems following operating procedures.[6]

---

1 The survey found that 83 percent of respondents considered IRS representatives their "most heavily relied upon source of tax information and advice." Additionally, the survey found that 83 percent relied on paid tax professionals, 82 percent relied on IRS printed materials, and 77 percent relied on the IRS website. IRS Oversight Board Annual Report 2004, 16 (referencing the RoperASW, 2003 IRS Oversight Board Annual Survey on Taxpayer Attitude, Sept. 2003, 17).

2 The W&I toll-free tax law accuracy rate target for FY 2004 was 85 percent. Wage and Investment Division, *Strategy and Program Plan, FY 2004 – 2005*, 173. Data for FY 2004 indicate that W&I achieved a tax law accuracy rate of 80 percent. Enterprise Telephone Data Warehouse, Weighted Customer Accuracy Reports – FY 2004 (Comparing FY 2003 and 2004 data).

3 Enterprise Telephone Data Warehouse, Weighted Customer Accuracy Reports – FY 2002; Enterprise Telephone Data Warehouse, Weighted Customer Accuracy Reports – FY 2003; Enterprise Telephone Data Warehouse, Weighted Customer Accuracy Reports – FY 2004.

4 Treasury Inspector General for Tax Administration, *Toll-Free Account Assistance to Taxpayers is Professional and Timely, but Improvement is Needed in the Information Provided*, Reference No. 2004-40-057, 6 (Feb. 2004), (The IRS strongly opposed TIGTA's characterization of inaccurate responses), and Treasury Inspector General for Tax Administration, *Additional Effort Answering Tax Law Questions Would Improve Customer Service*, Reference No. 2004-40-150, 6 (Aug. 2004).

5 Treasury Inspector General for Tax Administration, *Toll-Free Account Assistance to Taxpayers is Professional and Timely, but Improvement is Needed in the Information Provided*, Reference No. 2004-40-057, 23-24 (Feb. 2004).

6 Treasury Inspector General for Tax Administration, *Taxpayer Assistance Center Employees Correctly Answered More Tax Law Questions During November and December 2003 Than Compared to One Year Ago*, Reference No. 2004-40-090 (April 2004).

ANALYSIS OF PROBLEM

Toll-Free Telephone Services

Wage & Investment has expended significant resources to increase tax law and account information accuracy in its Toll-Free Telephone Assistance program. In October 2002, the IRS implemented the Embedded Quality Review System (EQRS), which links employee performance to organizational results, to measure the quality of taxpayer assistance. Performance measures include timeliness, professionalism, and accuracy (comprised of customer, regulatory, and procedural accuracy). This system, which replaced the previous "pass/fail" method, is designed to distinguish between wrong answers and procedural defects that do not affect the accuracy of the answer.[7]

Every filing season, IRS management certifies that all customer service representatives (CSRs) have received appropriate training on communication with taxpayers, tax law, and IRS procedures. The CSRs are required to follow the Internal Revenue Manual (IRM), which provides instructions on responding to taxpayer questions. The CSRs are also encouraged to use the Account Resolution Guide, a condensed and more user-friendly version of the IRM.[8]

Early in FY 2002, the IRS began to provide specialized training and certification to the CSRs who staff the Toll-Free lines.[9] Each CSR was given responsibility for a strictly limited set of topics. As a result, accuracy rates increased from FY 2001 to FY 2002.[10] However, this approach also created problems for the taxpayer because a single CSR could no longer answer broad questions and some CSRs had limited understanding of the implications of "cross-over" topics.[11]

In FY 2004, the IRS attempted to counter the problems associated with increased specialization by authorizing CSRs to answer broader tax questions than allowed by their previous limited set of topics. According to W&I, the "learning curve associated with the increase in assistors answering certain tax law topics for the first time was underestimated, resulting in a decline in tax law customer accuracy."[12]

[7] Treasury Inspector General for Tax Administration, *Additional Effort Answering Tax Law Questions Would Improve Customer Service*, Reference No. 2004-40-150, 18 (Aug. 2004).

[8] Treasury Inspector General for Tax Administration, *Toll-Free Account Assistance to Taxpayers is Professional and Timely, but Improvement is Needed in the Information Provided*, Reference No. 2004-40-057, 8 (Feb. 2004).

[9] The responsibilities of a CSR include: (1) answering account inquires, (2) answering tax law questions (3) providing taxpayers with information on the status of their returns/refunds and (4) resolving the majority of issues and questions to settle their accounts.

[10] W&I, Commissioner's Monthly Performance Business Summary, 3 (Sept. 30, 2002) (reporting that tax law accuracy rose from 75.2 percent to 81.2 percent and accounts accuracy rose from 69.2 percent to 74.1 percent between FY 2001 and FY 2002).

[11] W&I Weekly Filing Season Highlights for week ending February 6 and March 19, 2004.

[12] *Id.*

When compared to data over the last three fiscal years, Toll-Free data for tax law and accounts accuracy have declined overall, with accounts accuracy increasing slightly in FY 2004, but still below the FY 2002 accuracy rate, as shown in the following chart:[13]

TABLE 1.4.1, W&I TAX LAW AND ACCOUNTS ACCURACY RATE, FISCAL YEARS 2002 TO 2004.

Category	FY 2002 Actual[14]	FY 2003 Actual[15]	FY 2004 Actual[16]	FY 2004 Plan
Tax Law	84.4%	81.8%	80.0%	85.0%
Accounts	90.5%	88.7%	89.8%	90.2%

In an audit of the Toll-Free system, TIGTA found a decrease in accuracy rates for tax law questions, based on IRS EQ Attributes. Of the judgmental sample of 336 tax law calls monitored from January through February 2004,[17] only 62 percent of the questions (200 of 322 opportunities) were answered accurately,[18] a decrease from 73 percent in an audit the previous year.[19] Moreover, TIGTA reported that most inaccurate answers were given because CSRs did not use or did not fully use the Probe and Response Guide (P&R Guide), which gives the CSRs scripts to follow to ensure that they address all issues related to the taxpayer's particular question. Other inaccurate answers were given because the CSRs did not correctly interpret the tax law.[20] However, despite the falling rate of tax law accuracy, TIGTA found that taxpayers are receiving professional and timely service from the CSRs.[21] W&I responded to the findings by acknowledging the need to improve accuracy and by noting the improvement in accuracy rates in the periods following the audit.[22]

[13] Tax law calls address procedural or tax law information. Accounts calls address individual or business account questions, entity information, processing of a tax return, correction of errors found during processing and corrections resulting from adjustments or examination assessments, procedural issues or any other question on refunds or procedures.

[14] Enterprise Telephone Data Warehouse, Weighted Customer Accuracy Reports – FY 2003 (Comparing FY 2002 and 2003 data).

[15] *Id.*

[16] *Id.*

[17] TIGTA used a judgmental sample of tax law calls due to limited TIGTA staff resources. Treasury Inspector General for Tax Administration, *Additional Effort Answering Tax Law Questions Would Improve Customer Service*, Ref. No. 2004-40-150, 12 (Aug. 2004).

[18] The IRS reported an accuracy rate of 74 percent (1,132 of 1,527) during the same time period in 2004. *Id.*, at 9.

[19] *Id.* at 6.

[20] *Id.*

[21] Using IRS Embedded Quality Attributes, TIGTA found that CSRs delivered professional and timely service 98 percent of the time. *Id.*, at 7-9.

[22] Between January and May 2004, the tax law accuracy rate increased by 9.1 percent. *Id* at 23-24.

The IRS has also committed to redesigning the P&R Guide to make it more user-friendly.[23]

In an audit that drew a strong response from W&I, TIGTA monitored a judgmental sample of Toll-Free customer account calls during April and May of 2003.[24] TIGTA found a 78 percent accuracy rate, with CSRs providing accurate answers in 149 out of 191 taxpayer account calls. The audit reported that CSRs provided incorrect answers in the remaining 42 calls because they failed to follow procedures required by the IRM.[25] TIGTA also stated that the IRS reported a significantly higher accuracy rate of approximately 88 percent on account calls for the same period.[26] The ten percent difference can be explained by TIGTA's broader definition of what constitutes an inaccurate response.

The IRS strongly disagreed with TIGTA's characterization of defects relating to the disclosure authentication process. Specifically, TIGTA reported as errors in customer accuracy those circumstances under which the CSRs improperly provided information to individuals without asking all the questions required by the identification probe. The IRS does not include those defects in the customer accuracy rate, because they do not result in incorrect responses or resolutions to cases or issues.[27] Further, the defect in the authentication process is already taken into account when it is reported and documented for purposes of the Embedded Quality Review System.[28]

TAXPAYER ASSISTANCE CENTERS

Another recent TIGTA audit found improvement in the accuracy of responses to tax law questions at IRS Taxpayer Assistance Centers (TACs), formerly known as "walk-in sites." According to TIGTA, overall accuracy rose from 54 percent in December 2002 to 71 percent in December 2003.

TIGTA acknowledges that the increase is directly related to the corrective actions taken by the IRS in response to TIGTA's previous audit results.[29] However, TIGTA also found

---

[23] Treasury Inspector General for Tax Administration, *Additional Effort Answering Tax Law Questions Would Improve Customer Service*, Reference No. 2004-40-150, 23-24 (Aug. 2004). .

[24] Due to limited TIGTA staff resources, TIGTA selected a judgmental sample of 229 calls from an estimated population of approximately 2.7 million toll-free account calls. Thirty-eight calls dropped out of the sample due to transfers, disconnects and TIGTA's inability to research the accounts. Treasury Inspector General for Tax Administration, *Toll-Free Account Assistance to Taxpayers is Professional and Timely, but Improvement is Needed in the Information Provided*, Reference No. 2004-40-057, 2, 15 (Feb. 2004). Note: A judgmental sample cannot be generalized to the population.

[25] *Id.* at 8.

[26] *Id.* at 6-8.

[27] IRM § 21.10.1.2.8 provides that "[f]or the purpose of coding [the customer accuracy] attribute, do not take into consideration any additional IRS issues or procedures that do not directly impact the taxpayer's issue or case."

[28] Treasury Inspector General for Tax Administration, *Toll-Free Account Assistance to Taxpayers is Professional and Timely, but Improvement is Needed in the Information Provided*, Reference No. 2004-40-057, 23-24 (Feb. 2004).

[29] TIGTA visited 36 TAC locations and asked 138 tax law questions. Treasury Inspector General for Tax Administration, *Taxpayer Assistance Center Employees Correctly Answered More Tax Law Questions During November*

weaknesses in the system. While 71 percent of the questions posed were accurately answered, approximately ten percent of the correct answers were provided without the TAC employee asking pertinent questions, the answers to which, according to TIGTA, could have impacted the answer.[30]

IRS guidelines require employees to use publications and instructions as tools in answering questions. When the employee fails to use the appropriate tools and does not ask the right questions of the taxpayer, the employee is not taking necessary steps to ensure the accuracy of his or her response.[31]

Further, employees who are asked "out of scope questions" that exceed their training are required to refer these questions to the Toll-Free telephone service or R-mail.[32] Despite the IRS guidelines, 25 percent of the "out of scope questions" posed were not properly referred, and 40 percent of those improperly retained questions were answered incorrectly.[33]

IRS COMMENTS

Toll-Free Telephone Services

As noted in the TAS report, the IRS has expended significant resources to increase tax law and account information accuracy in its Toll-Free Telephone Assistance program, and this effort will continue. The report indicates that in FY 2004, tax law accuracy rates declined because CSRs were authorized to answer a broader range of topics and that accuracy rates were higher in FY 2002 when CSRs were allowed to answer only a limited set of topics. Specialization, however, created problems for the customer because one CSR could not answer a wide range of questions posed by a customer, and therefore, he or she had to transfer the call to another CSR for final resolution. Widening the scope of topics was

and December 2003 Than Compared to One Year Ago, Reference No. 2004-40-090 (April 2004), 3. Although the IRS concurred with TIGTA's findings, it should be noted that the IRS has continually disagreed with TIGTA's inclusion of referrals to publications and service denials when computing accuracy rates. See Treasury Inspector General for Tax Administration, *Taxpayer Assistance Center Employees Correctly Answered More Tax Law Questions During September and October 2003 Than Compared to One Year Ago*, Reference No. 2004-40-037, 14-16 (Jan. 2004).

30 Ten (10) of 98 correct answers were provided to the taxpayers without the employee asking the taxpayers all of the required questions. Treasury Inspector General for Tax Administration, *Taxpayer Assistance Center Employees Correctly Answered More Tax Law Questions During November and December 2003 Than Compared to One Year Ago*, Reference No. 2004-40-090 (April 2004), 4 (IRS concurred with audit report by email).

31 *Id.*

32 R-mail is a CAS referral system established to answer tax law questions during filing season. The customer's contact information along with the question is documented and entered into the r-mail system. The questions are separated by tax law categories and referred electronically to a specialist who responds back to the taxpayer with the answer.

33 Treasury Inspector General for Tax Administration, *Taxpayer Assistance Center Employees Correctly Answered More Tax Law Questions During November and December 2003 Than Compared to One Year Ago*, Reference No. 2004-40-090, 6-7 (April 2004).

done to address the high percentage of calls transferred and the resulting customer dissatisfaction. Having to be transferred to multiple CSRs and waiting in queue for the associated additional time were top customer complaints. This action, along with others aimed at improving service, resulted in increased customer satisfaction, less calls transferred, and more calls answered. The "Time to Get to the Right Person" category of the customer satisfaction survey improved from 4.29 (January – March 2003) to 4.51 (January – March 2004) with 5 being very satisfied.

IRS is committed to redesigning the Probe and Response (P&R) Guide to make it more user-friendly. It should be noted that after different models were considered and field validations conducted, the newly designed guide was made available to all employees for training purposes in October 2004. Mandatory topic-specific training has been developed and will be delivered to all CSRs to ensure their familiarity with the new design and content prior to the beginning of the 2005 filing period.

The report cites findings of TIGTA audits and states the sample of tax law and account calls reviewed during the audits produced lower accuracy rates than reported by IRS. It is important to note that the TIGTA audit samples are judgmental, which means the samples are not statistically valid, unlike those reported by IRS. The IRS Centralized Quality Review Site uses call volume and accuracy rates to achieve a statistically valid measurement of quality performance on both the tax law and account telephone product lines.

The IRS acknowledges the need to improve the accuracy of toll-free telephone responses and is taking action aimed at improvement in FY 2005.

The scope of tax law issues will remain static. As CSRs gained expertise on the additional topics in FY 2004, accuracy rates steadily improved as the year progressed. IRS began the filing period at 75.2 percent accuracy and accomplished monthly accuracy rates above 80.0 percent starting in March and maintained those rates through the end of the fiscal year.

The P&R Guide has been redesigned for FY 2005 to a format similar to that used in FY 2002, the year IRS achieved its highest tax law accuracy.

Taxpayer Assistance Centers

The IRS agrees that employees must follow Field Assistance (FA) operating procedures. Field Assistance continues to provide topic-specific training to employees and emphasize that employees must ask all probes in the Publication Method Guide (PMG) when answering tax law questions. The PMG was created to provide an easy-to-use tool to guide Field Assistance employees through the complex maze of tax laws and computations. The PMG helps employees answer tax law questions in a precise, correct and efficient manner. All Field Assistance employees are required to use the PMG when answering tax law questions.

Field Assistance completed a number of actions designed to ensure that IRS employees use the PMG when assisting customers:

- Established a zero tolerance for employees referring customers to publications to find answers to their tax law questions.
- Delivered a lesson on the PMG to all employees during the FY 2003 Continuing Professional Education (CPE) classes.
- Implemented the Certification process that requires employees to successfully pass tests related to specific tax law topics before they can answer customer questions related to those topics.
- Presented CPE tax law topics using the PMG.
- Reinforced the use of the PMG through directed learning (one hour per week)
- Required managers to observe employee contacts with customers to ensure employees follow procedures.

Field Assistance employees are counseled when managers identify an improper referral, a failure to use the PMG, and a response to an out of scope question. There is follow up with education and role-playing to demonstrate proper use of the PMG.

TAXPAYER ADVOCATE SERVICE COMMENTS

To facilitate voluntary compliance, the IRS needs to make every effort to accurately answer those tax law questions posed by taxpayers attempting to comply with the tax laws. These efforts will reduce taxpayer burden by capturing the correct amount of tax on the return and avoiding future enforcement actions against well-intentioned taxpayers. As we have noted above, the ever-increasing complexity of the tax laws makes it very challenging for the IRS to increase, or even maintain, the accuracy of its tax law responses.

We commend the IRS for the various corrective actions taken to address tax law and account accuracy on the Toll-Free telephone service and at the TACs. While the IRS has committed to continue striving for world class customer service, it appears the agency faces many challenges in meeting the needs of taxpayers.[34] *It is difficult to balance the need to improve accuracy rates with the need to improve customer satisfaction ratings. Broadening the range of topics assigned to CSRs may increase customer satisfaction by reducing customer wait times and call transfers, but this improvement potentially occurs at the expense of tax law accuracy. If the IRS decreases specialization, the agency must commit to devote enough resources to properly train employees to handle their broader range of assigned topics. Based on Toll-Free data provided in the IRS Comments, the steady improvement in accuracy rates is a favorable indication that CSRs are receiving sufficient training to gain expertise*

[34] Department of the Treasury: Hearing Before the Senate Committee on Finance, 108th Cong, 1st Sess., March 18, 2003 nomination of Mark W. Everson to be Commissioner of Internal Revenue (Statement of Mark W. Everson, Nominee).

on their additional assigned topics. Furthermore, pursuant to the IRS Comments, the establishment of a zero tolerance policy for employees referring taxpayers to publications is a significant improvement in customer service.

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations with respect to the Accuracy of Tax Law and Accounts Assistance:

- *The IRS needs to continually monitor tax law and account accuracy rates at the TACs and on the Toll-Free telephone service to determine the effectiveness of the corrective actions taken. The training provided to employees must be tailored to the findings of these reviews in order to sufficiently meet the changing needs of the employees and address emerging issues.*
- *W&I should continue to explore ways to achieve other goals, such as lowering customer wait time and multiple transfers, without adversely impacting the accuracy of its responses.*
- *W&I should consider sponsoring research to determine the comparative implications of various items, such as improved accuracy rates and shorter wait times, on taxpayer compliance. For example, will taxpayers tolerate longer wait times and one or two transfers if they understood that they will ultimately receive more accurate answers? The results of this research should assist the IRS in designing a long-term solution to this issue rather than merely reacting to periodic customer satisfaction surveys.*
- *Although the IRS believes that defects in the disclosure authentication process should not impact accuracy rates, authentication is essential to taxpayer privacy. Accordingly, the agency should commit to continually monitor this item on a regular basis.*

PROBLEM
TOPIC A-5

MOST SERIOUS PROBLEM: EDUCATION AND OUTREACH ISSUES

RESPONSIBLE OFFICIALS

Henry O. Lamar, Jr., Commissioner, Wage and Investment Division
Kevin M. Brown, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

Complexity in the tax law and its administration can easily baffle taxpayers and lead to compliance problems. The National Taxpayer Advocate is concerned that inadequate planning for taxpayer education and outreach may significantly impact compliance in an ever-changing, complex tax environment. With the IRS placing more emphasis on enforcement, and shifting resources from pre-filing to post-filing activities, taxpayers may not receive the education and assistance they require to comply with their tax obligations.[1]

Pre-filing initiatives are designed to help prevent errors that are attributable to inadvertent mistakes, as opposed to deliberate misreporting of income. Increased pre-filing outreach targeted at taxpayers who are susceptible to making these errors should reduce the chances of them being unnecessarily subjected to the harsher post-filing initiatives. The National Taxpayer Advocate believes this preventive strategy results in fewer taxpayers needing to be addressed by the alternative "gotcha" approach to tax assessment and collection.

The National Taxpayer Advocate has identified four major areas of concern regarding the IRS' education and outreach initiatives:

- **Shift in IRS Emphasis to Compliance** – The IRS is shifting its emphasis from pre-filing and service activities to the more traditional compliance and enforcement areas, a decision reflected in the IRS' allocation of resources for the coming years.
- **Inadequate Planning** – As part of the reorganization that began after 1998, the IRS incorporated education and outreach units within its major operating divisions. However, the IRS has not conducted adequate planning and analysis based on an understanding of its customer base, available methods of delivering education and outreach, or other quantitative measures.
- **Method of Delivery** – The IRS has shifted its emphasis from direct taxpayer contact initiatives to indirect outreach that relies on intermediaries. However, the IRS has yet to determine whether the information provided has the desired impact or remains accurate when delivered by partners.

[1] Pre-filing makes up only 5.9 percent of the Internal Revenue Service's (IRS) FY 2005 budget. Filing and Account Services are allocated 16.4 percent; Compliance is allocated 40.2 percent. IRS, *Budget in Brief Fiscal Year 2005*, Catalog No. 23819V, (February 2004), 6.

- **Measurement of Effectiveness** - The IRS lacks adequate means to measure the effectiveness of its efforts to address tax complexities through education and outreach.

ANALYSIS OF PROBLEM

IRS services fit into three general categories: pre-filing, filing, and post-filing. Pre-filing includes education and outreach initiatives that taxpayers may utilize before sending in their returns.[2] Filing services are provided to a taxpayer in the process of filing a return and paying taxes, including electronic filing and payment. Post-filing services (traditionally known as compliance) begin after a return is filed to identify underreporting, non-filing, and nonpayment.[3]

In the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Congress directed the IRS to "place a greater emphasis on serving the public and meeting taxpayers' needs."[4] To comply with this mandate, the IRS revised its mission statement, which now reads: "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."[5]

Facilitating voluntary compliance is especially important because the U.S. tax system relies on taxpayers to self-assess and voluntarily pay the appropriate tax due. In fact, about 98 percent of all tax revenue collected is paid through withholding, remittances sent with returns, or other forms of payment without any IRS enforcement action.[6]

With IRS activities swinging back toward compliance and enforcement, the IRS has an even more compelling need for pre-filing education and outreach. Achieving balance between enforcement and service is vital. The IRS Oversight Board defines balance as "helping taxpayers understand their obligations in an increasingly complex tax system while at the same time identifying and pursuing those who flout the tax code."[7]

With the enactment of RRA 98, each of the four IRS operating divisions (ODs) became responsible for providing education and pre-filing assistance to its own customer base. The four ODs serve taxpayers as follows:

- *Wage and Investment (W&I):* Individual taxpayers with wage and investment incomes (e.g., Form 1040 filers).

[2] IRS, *FY 2004 IRS Annual Performance Plan*, Strategic Content, (February 3, 2003), 3.

[3] *Id.*

[4] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 1002.

[5] IRS, *The Agency and Its Mission*, available at http://www.irs.gov.

[6] General Accounting Office (GAO), *IRS Modernization Continued Progress Necessary for Improving Service to Taxpayers and Ensuring Compliance*, GAO-03-796T, 19 (May 20, 2003).

[7] IRS, *IRS Oversight Board FY 2005 Budget/Special Report*, 11, (March 2004).

- *Small Business/Self-Employed (SB/SE):* Businesses and self-employed individuals with assets under $10 million.
- *Large and Mid-Size Business (LMSB):* Corporations, subchapter S corporations, and partnerships with assets greater than $10 million.
- *Tax Exempt and Government Entities (TE/GE):* Exempt Organizations (EO), Employee Plans (EP), and Government Entities (GE).

We limit our analysis below to the education and outreach efforts of W&I and SB/SE. LMSB's strategic assessment plan for fiscal years 2004-2006 does not set forth any goals for education and outreach, nor does it assess the division's education and outreach needs.[8] For a discussion of TE/GE's education and outreach strategy please refer to Most Serious Problem number 13, *Application and Filing Burdens on Small Tax Exempt Organizations*.[9]

Analysis of Wage and Investment

The Wage and Investment (W&I) division serves approximately 122 million taxpayers and processes approximately 94 million returns annually. As a group, W&I taxpayers are highly compliant. When compliance issues do arise, they are often the result of a taxpayer's confusion and are detected through technology-based matching programs. While more than half of W&I taxpayers now hire tax practitioners, tens of millions of individual filers still prepare their own returns.[10] This presents a great opportunity for the division to provide top quality service to a large number of taxpayers who otherwise would not receive assistance, and have the greatest need for guidance in preparing correct returns.

Within W&I, pre-filing programs are the responsibility of Stakeholder Partnerships, Education and Communication (SPEC).[11] SPEC organizes initiatives to reduce taxpayer burden, increase the quality and efficiency of communication and services, or expand electronic filing.[12] The unit functions as an intermediary between taxpayers and other IRS program owners. SPEC's Strategic Planning office is located at its headquarters in Washington, DC.[13] SPEC's Field Operations are divided into four Area Offices and 42 Territory Offices throughout the United States.[14]

---

[8] IRS, *Large and Mid-Size Business Division - Business Performance Plan*, 11, (July 23, 2004).

[9] *See* Most Serious Problem, *Application and Filing Burdens on Small Tax-Exempt Organizations*, infra.

[10] IRS compliance data warehouse, form 1040 Returns from Individual Return Transaction file, Electronic Tax Administration Advisory Committee, Annual Report to Congress, Publication 3415 (Rev. 6-2003), 4.

[11] This analysis section does not address SPEC's outreach and education on the Earned Income Tax Credit, which has a specific dedicated strategy.

[12] IRS, *Summary Strategy and Program Matrix for Wage and Investment, Wage and Investment Strategy and Program Plan FY 2003-2004*, 52-54.

[13] IRS, *Wage & Investment Division Organization Chart*, November 10, 2004.

[14] IRS, *SPEC Field Operations – New Area and Territory Structure*, November 10, 2004. In FY 2004, SPEC consolidated its seven Area offices into four Area offices.

MOST SERIOUS PROBLEMS

SPEC employees who conduct education and outreach events are required to possess a basic knowledge of accounting principles, tax law, IRS procedures and regulations, as well as marketing, planning, coordination, and written and oral communication skills.[15] These employees have been able to foster relationships with stakeholders in the community and seem to have open lines of communication with those stakeholders.

SPEC is a separate and dedicated unit that has little interaction with other W&I functional groups. For example, SPEC employees hold meetings and training sessions apart from other W&I employees. Due to this isolation, the National Taxpayer Advocate is concerned that there is a disconnect between what SPEC employees learn from their partners in the community and the information the IRS relays to employees working compliance issues. It is important for SPEC to adequately address follow-up issues that stakeholders and taxpayers may have and be able to elevate questions or concerns to the national level when appropriate.

In its 2004 annual report, the IRS Oversight Board concluded that low income taxpayers in particular face a significant burden in communicating with the IRS via streamlined and centralized processes, and recommended that this population receive more education and instruction.[16] While SPEC has succeeded in creating partnerships with community-based organizations that have access to the low income taxpayer population, the unit needs to conduct research to determine whether this indirect contact is an effective means of communication.

SPEC also needs to consider taxpayers' attitudes toward various types of contact with the IRS. For example, do taxpayers respond better to telephone contact than to mailed correspondence? One IRS study found that a substantial majority of taxpayers seeking technical assistance who had live (87 percent) or telephone (81 percent) contact with the IRS felt the assistance helped them meet filing obligations, while less than half of the taxpayers found correspondence helpful.[17] SPEC needs to initiate more research to determine what messages should be conveyed by partners, the most effective means of ensuring accurate re-delivery through partners, and the level of assistance to provide to the partners to ensure this accuracy.

The few studies that SPEC has conducted did not conclusively indicate that its education and outreach activities improved compliance.[18] Nor is there much understanding of what SPEC's partners need for true, active, continuing support or monitoring of the message.

[15] IRS Position Description, Tax Law Specialist GS-987–12, No. 93163, 2-3 (July 12, 2002).

[16] IRS, *IRS Oversight Board Annual Report 2004*, xii (August 3, 2004).

[17] IRS 1990 Research Conference: How Do We Affect Taxpayer Behavior? The Case for Positive Incentives, Assistance or Enforcement, *The Effect of Taxpayer Service on Compliance*, Table 3.

[18] IRS, *Impact of Coalitions (Upstate New York)*, Project 2-03-02-2-013E (September 2003); and *Outreach Measurement Test, Rio Grande EITC*, Project 1-03-02-2-051E (November 6, 2003).

The following table compares the numbers of taxpayers assisted directly and indirectly by W&I. Indirect or leveraged contact includes delivery of products and services by a SPEC partner, including mass media such as newspaper, television and radio. Direct contact generally includes IRS outreach activities, such as seminars, training and mail campaigns.[19]

TABLE 1.5.1, COMPARISON OF W&I TAXPAYERS ASSISTED BETWEEN FY 2003 AND 2005

Critical Measures	FY 2003[20]	FY 2004[21]	FY 2005 Target[22]
Number of Taxpayer Contacts-Direct	372,326	125,763	165,000
Number of Taxpayer Contacts-Indirect	38,191,740	73,664,944	67,500,000

With SPEC placing more emphasis on indirect (leveraged) taxpayer assistance, direct contacts with taxpayers have decreased compared to the same period in FY 2003. Conversely, indirect taxpayer assistance has soared from a little over 38 million taxpayers in FY 2003 to over 73 million in FY 2004.

The large increase in indirect taxpayer contacts in FY 2004 is a result of SPEC's effort to utilize indirect channels as the primary means of delivering assistance.[23] While partnering with stakeholders in the community has its advantages, SPEC must be careful not to rely on its partners exclusively and avoid direct contact with taxpayers.

Tracking the number of taxpayer contacts by itself does not provide an adequate measure of an outreach program's effectiveness. The National Taxpayer Advocate concurs with the Treasury Inspector General for Tax Administration's (TIGTA) recent recommendation that W&I needs to develop long-term goals and a measurement process to enable management to monitor the effect of its initiatives on voluntary compliance for W&I taxpayers.[24] While W&I may be reaching more taxpayers, it does not have any meaningful measurements in place to determine if the services provided are meeting the taxpayers' needs or increasing compliance.

[19] For fiscal year 2002, direct contact included taxpayers assisted through outreach, the number of returns prepared (both state and federal), questions answered, and forms provided. For FY 2003 and subsequent years, the definition of direct contact was modified to include only outreach (e.g. seminars, training, and mail campaigns) and the actual number of federal returns prepared. IRS, *Wage and Investment Measures and Workload Indicators, Wage and Investment Strategy and Program Plan FY 2003-2004*, 149-152.

[20] IRS, *Wage & Investment Business Performance Review* (July 28, 2003).

[21] IRS, *Business Management System, Wage & Investment, Final FY 2004.* Budget Activity Code (BAC) 21- Pre-Filing Programs.

[22] IRS, *Wage & Investment Business Performance Review*, 10, (February 12, 2004).

[23] *Id* at 10, 11.

[24] Treasury Inspector General for Tax Administration, *Information Is Needed to Determine the Effect the Wage and Investment Division Research Program Has on Improving Customer Service and Voluntary Compliance*, Reference No. 2004-40-088, 2 (April 2004).

TABLE 1.5.2, COMPARISON OF W&I STAFF YEARS ALLOCATED TO EDUCATION AND OUTREACH ACTIVITY

Item	FY 2002	FY 2003	FY 2004
Total projected staff years for education and outreach activity[25]	560	650	675
Total actual staff years for education and outreach activity[26]	562	651	637
Percentage of difference[27]	0.4%	0.2%	-5.6%

Table 1.5.2 above shows that in FY 2004, W&I realized a shortfall of nearly six percent in actual staffing compared with projected staffing. With SPEC focused on leveraging its education and outreach efforts, this reduction in staffing comes as no surprise. This may be the appropriate model, but because SPEC has not studied or measured the effectiveness of its outreach, we are unable to determine whether a reduction in staffing is a sign of progress or an indication of a problem. This lack of research indicates that the IRS is making staffing decisions without regard to their effect on taxpayers, which does present a problem.

Analysis of Small Business/Self-Employed

The Small Business/Self-Employed (SB/SE) division serves approximately seven million small businesses, including corporations and partnerships with assets of $10 million or less. While many of these taxpayers face some of the same tax issues as large corporations, they often do not have tax professionals on staff. The approximately 33 million self-employed and supplemental income earners are similar to W&I taxpayers, but their issues are often more complex. SB/SE also serves estate and gift taxpayers, fiduciary taxpayers, and individuals with international returns.[28]

The Taxpayer Education and Communication (TEC) operation unit handles pre-filing activities for SB/SE. TEC's mission is to educate and inform SB/SE taxpayers and representatives about their tax obligations by developing educational products and services focused on customer needs, and by providing pre-filing services to help taxpayers understand and comply with the law.[29] The Director of TEC has two separate offices in its Washington, DC, headquarters – one for Partnership Outreach and one for Special

[25] *IRS, Wage & Investment Strategy and Program Plan, Summary Strategy and Program Matrix for Wage and Investment FY 2003 - FY 2004*, Wage and Investment Division Resource Matrix, 7 (September 16, 2002). The total staff years include figures for the Budget Activity Code (BAC) 21 (Pre-Filing) with Program Activity Code (PAC) 1C (Taxpayer Communication & Education) plus the staff years dedicated to BAC 80 (Earned Income Tax Credit) and PAC 1C.

[26] IRS, *Stakeholder, Partnerships, Education and Communication* PowerPoint, July 29, 2004, 10. FY2004 figures are projected figures.

[27] Computation for FY 2002 projected vs. actual staff years is (562-560)/560 = 0.4 percent for FY 02; (651-650)/650 = 0.2 percent for FY 2003; and (637-675)/675 = -5.6 percent for FY 2004.

[28] IRS, *Small Business/Self-Employed Division At-a-Glance*, available at http://www.irs.gov.

[29] General Accounting Office, *Tax Administration – Workforce Planning Needs Further Development for IRS's Taxpayer Education and Communication Unit*, GAO-03-711 (May 2003).

Programs and Oversight. TEC Field Operations is comprised of four Area Offices throughout the United States.[30]

The National Taxpayer Advocate is concerned that valuable information learned by TEC Field Operations employees from direct contacts is not systemically passed on to the individuals who design and implement SB/SE compliance programs. The knowledge base of the talented and motivated Field Operations staff is not integrated into the decision-making structure of SB/SE. This disconnect limits TEC's effectiveness and hinders its ability to serve its customers.

In May 2003, the General Accounting Office (GAO, now known as the Government Accountability Office) released a report that analyzed and raised concerns about TEC. The GAO concluded that "[a]lthough it has existed for more than two and a half years, TEC does not have a strategic workforce plan that included certain critical elements. For example, it has not identified gaps between the number, skills, and locations of its current workforce and the workforce it will need in the future, and the strategies to fill gaps."[31]

The table below shows the number of taxpayers reached by SB/SE outreach from FY 2002 through FY 2004. As is the case with W&I, direct contact with SB/SE taxpayers has decreased. TEC's critical measure for taxpayers reached directly has a steady downward trend from over 400,000 in FY 2002 to approximately 175,000 in FY 2004. Conversely, the number of indirect contacts is projected to increase significantly from FY 2003 to FY 2004.

TABLE 1.5.3, NUMBER OF TAXPAYERS REACHED BY SB/SE EDUCATION AND OUTREACH INITIATIVES

Taxpayer Education and Communication Critical Measures	FY 2002[32]	FY 2003[33]	FY 2004[34]
Number of Taxpayer Reached-Direct	401,507	303,012	175,047
Number of Taxpayer Reached-Indirect	—	5,505,421	6,449,569

SB/SE defines critical measures slightly differently than W&I. "Number of taxpayers reached – direct" refers to the number of SB/SE taxpayers and practitioners reached through direct (face-to-face, substantial) contact with TEC personnel and/or through the use of leveraged resources. "Number of taxpayers reached – indirect" refers to the number

[30] IRS, *SB/SE Organization Chart -- TEC* (November 10, 2004).

[31] GAO, *Tax Administration – Workforce Planning Needs Further Development for IRS's Taxpayer Education and Communication Unit*, GAO-03-711, 1 (May 2003).

[32] IRS, *Business Performance Management System, SB/SE Critical Measures Report, BAC 21 – Pre-Filing Programs*. SB/SE changed method for calculating the number of taxpayers reached indirect between FY 2002 and FY 2003.

[33] IRS, *Business Performance Management System, SB/SE Monthly Summary Final FY 2004*. Codes 18 and 5.

[34] *Id.*

of SB/SE taxpayers reached indirectly through contact with practitioners.[35] For example, SB/SE counts as an indirect contact the number of practitioners who attend outreach events multiplied by the average number of clients per practitioner.[36]

An effective outreach activity is one that delivers an accurate message to a targeted audience that understands the message. It is difficult to determine the effectiveness of the outreach solely from the number of customers reached. The IRS should, at a minimum, measure whether the message was accurately conveyed (by the IRS itself or via a third party) and understood by the intended audience.

TEC has attempted to measure the impact of education and outreach on voluntary tax compliance. The organization concluded that outreach slowed the growth of Federal Tax Deposit penalties, decreased the rate and average amount of Failure to File penalties, and reduced the frequency and severity of balance due accounts.[37] TEC has also conducted several customer satisfaction surveys to determine if its programs met customers' expectations.[38] While limited in nature, these studies and surveys show that SB/SE is moving in a positive direction to identify taxpayer needs and measure the effectiveness of outreach.

TABLE 1.5.4, COMPARISON OF SB/SE STAFF YEARS ALLOCATED TO EDUCATION AND OUTREACH ACTIVITY

Staff years for SB/SE taxpayer education and outreach activity	FY 2002	FY 2003	FY 2004
Total projected[39]	624	723	848
Total actual[40]	638	699	656
Percentage of difference between projected and actual[41]	2.2%	-3.3%	-22.6%

[35] IRS, *Business Measures DataMart - SB/SE Critical Measure Report*.

[36] Per interview with Senior Program Analyst, TEC, the average number of clients per practitioner was 71 (September 7, 2004).

[37] These studies were limited to specific population groups and the findings of these studies may or may not be relevant to other populations. IRS, *Analysis of Customer Survey Feedback on Taxpayer Education and Communication Outreach Activities on Offshore Voluntary Compliance Initiative* Project # 04.02.004.03, October 2003; and *Measuring the Effect of TEC Outreach on Construction Industry Employment Taxes*, Project # 06.08.004.03 (July 2004).

[38] IRS, *Summary of Results for Taxpayer Education and Communication (TEC), SB/SE – Stakeholder Satisfaction Survey* Research Project 04.02.002.04, July 2004; and *SB/SE – Profile of Form 941 Filers (Employer's Quarterly Federal Tax Return)* Research Project 04.01.001.04 (Sept. 8, 2004).

[39] IRS, *SB/SE Strategy and Program Plan FY 2003 – FY 2004*, Attachment 2 (Sept. 16, 2002). The FTEs for Budget Activity Code (BAC) 21 with Program Activity Code (PAC) 1C where used.

[40] Actual figures provided during interview with Senior Program Analyst, TEC (Sept. 7, 2004). FY 2004 results are from FY 2004 Small Business/Self Employed Summary of Resources by Function by Program Activity Code. Taxpayer Education and Communication staff years per column labeled Year to Date for PAC 1C = 656.49 actual staff years.

[41] Computation for FY 02 projected vs. actual staff years is (624-638)/624 = 2.2 percent for FY 02; (723-699)/723 = -3.3 percent for FY 03; and (848-656)/848 = -22.6 percent for FY 04.

Table 1.5.4 above shows that in FY 2004, TEC realized more than a 22 percent shortfall in actual staffing compared with projected staffing. In October 2004, SB/SE announced plans to further reduce its education and outreach staffing by launching an initiative to re-assign some employees from TEC to front-line enforcement positions.[42] The decline in resources allocated to education and outreach may be detrimental to taxpayers, particularly in light of the fact that SB/SE taxpayers generally face more complicated issues than taxpayers served by W&I and may require greater interaction with the IRS.

The National Taxpayer Advocate recognizes, however, that the effectiveness of an education and outreach program is not necessarily directly proportionate to the number of FTEs assigned. It is possible that TEC has found a way to use its resources more effectively than in prior years. Again, however, because the IRS has no way to measure the effectiveness of its outreach, we are unable to determine whether a reduced education and outreach staff is a sign of progress or an indication of a problem. It is disturbing to know that education and outreach decisions (such as staffing) are being made without regard to their benefit or harm to the taxpayer.

CONCLUSION

In sum, the National Taxpayer Advocate identifies four primary concerns with respect to the IRS's education and outreach strategy. First, we notice a shift in emphasis from pre-filing initiatives to compliance and enforcement. We are concerned that this shift will undermine the IRS' ability to comply with the congressional mandate to assist taxpayers in understanding their tax responsibilities.

Second, we are concerned that the IRS has not conducted adequate planning and analysis based on an understanding of the customer base, available methods of delivery, or other quantitative measures. Without a strategic plan to deliver the appropriate message to the targeted audience in an understandable manner, the IRS will be unable to implement an effective education and outreach program.

Third, we note the IRS trend of shifting its method of delivery from direct to indirect taxpayer contact. Although partnerships allow the IRS to leverage its message to reach more taxpayers, the IRS has yet to determine whether the information provided has the desired impact or retains accuracy in its delivery.

Fourth, we are concerned with the inadequacy of the IRS' measurements of the effectiveness of its education and outreach efforts. Merely determining the number of taxpayers reached provides no indication whether taxpayers received adequate (accurate and comprehensible) information to understand the tax laws and correctly comply with their tax obligations. A successful education and outreach program should focus on assisting taxpayers to be in compliance with tax obligations and gain an understanding of applicable tax laws.

[42] Commissioner, SB/SE, to the SB/SE Executive Team on October 19, 2004, and October 28, 2004.

IRS COMMENTS

Shift in IRS Emphasis to Compliance

The NTA has expressed concern regarding the pre-filing components of the IRS that involve outreach activities of the Wage & Investment (W&I) Division and the Small Business/Self-Employed (SB/SE) Division. The IRS' 2005 – 2009 Strategic Plan identifies service and enforcement as equal priorities in accomplishing the 2005 - 2009 strategic goals. The challenge is to determine the best way to achieve these goals. The IRS is examining the current structure of the pre-filing outreach and education programs to determine the most efficient way to continue an effective pre-filing outreach and educational program within the current budget.

In absolute terms, IRS has devoted more staff hours, technical resources, and new training and support products to outreach programs each year since the IRS reorganization in 2000. In response to the need to increase the accessibility of educational outreach to underserved W&I taxpayer and SB/SE taxpayer segments, the program has grown dramatically in three years. As the needs have grown, IRS has utilized a combination of leveraged (outreach through IRS partners) and direct methods (IRS direct delivery and Internet web page) to service millions of taxpayers and improve services in a flat budget environment. The leveraged model is not intended to rely on partners exclusively, or to avoid direct contact with taxpayers. Instead it allows IRS to maximize resource utilization in reaching as many taxpayers as possible.

In W&I, the primary focus is on underserved customer segments of individual taxpayers as follows: low-income, elderly, disabled, and limited-English proficient (LEP). In SB/SE the focus is on taxpayers in the small business community. With these two functions taking the lead in education and outreach in their respective markets, the IRS developed targeted partner and compliance-oriented outreach and assistance activities at both the national and local levels to increase the value of customer education, support and service delivery. The Service has concentrated on research-based compliance issues and has developed more focused outreach campaigns that target areas of non-participation and potential non-compliance in areas including but not limited to Earned Income Tax Credit (EITC)/Child Tax Credit (CTC), the TIP/TRAC (Tip Reporting Alternative Commitment) program, and Centralized Withholding Agreements as follows:

- *National Operating Priority for FY 2005 – EITC/CTC outreach.* The strategy addresses increasing penetration rates for eligible participants, raising EITC/CTC awareness, increasing EITC/CTC compliance (reducing erroneous claims), partnering with states that have similar credits for low income taxpayers, and effectively using EITC funding to impact FY 2005 filing behavior to include the LEP population.
- *Employment Tax Strategy.* An agency-wide employment tax strategy addresses the information and assistance needs of both the individual taxpayer and the business

taxpayer. Some initiatives are industry specific, i.e. restaurant and construction. These initiatives also provide information relative to employment tax returns, deposits, e-file and electronic payment options.

- *TIP/TRAC Program.* The TIP/TRAC program works with employers of those who receive tip income to conduct employee training on tax compliance. The TIP/TRAC agreements help both the employees and the employers meet their respective tax obligations without enforcement intervention
- *Centralized Withholding Agreements.* Centralized Withholding Agreements provide the opportunity to ensure income tax is collected from non-resident alien entertainers, athletes and similarly situated individuals who are subject to U.S. income tax withholding due to performances or participation in athletic events in the United States.
- *Other compliance efforts underway* – FERDI (Federal Employee Retiree Delinquency, Tax Exempt, E-Commerce, Non-Filers, and Multi-Lingual Initiatives)

Inadequate Planning and Interaction

Contrary to the NTA observation that IRS provides inadequate planning and interaction in support of outreach programs, the IRS has formal structured stakeholder/employee interaction and analysis of its customer base to refine continually its programs, methodologies and measures of program success. IRS uses research and a cross-functional approach during the strategic planning process.

IRS research is comprised of business results, customer segment data, empirical data, including partner and customer satisfaction surveys and qualitative data. Recognizing the need to make data driven decisions to target its outreach activities, IRS has designed and developed databases using both return and demographic information. These custom databases provide information at various geographic levels. The databases (i.e. EITC and E-file) allow IRS to specifically target areas with the most need for outreach and educational services.

IRS has liaison representation on cross-functional internal and external forums. Examples of internal forums include local Stakeholder Relationship Management Councils, ETA Marketing Council and the EITC Committee. The IRS coordinates cross-functional meetings among various functions during the strategic planning process to identify compliance, EITC awareness, and IRS workload issues that are appropriate for developing and delivering outreach initiatives. The cross-functional participation provides opportunities to coordinate outreach efforts and to raise and address stakeholder/taxpayer concerns.

Externally, IRS gains input from forums such as the Taxpayer Advocacy Panel and the IRS Oversight Committee. For example, as a result of a discussion with the Taxpayer Advocacy Panel, IRS and IRS partners are launching a Rural Strategy pilot in FY 2005 that will provide targeted outreach and volunteer return preparation services for low-income W&I taxpayers in rural areas. The results of the pilot will formulate the basis for expansion to other rural areas nationwide.

The IRS forms partnerships, establishes relations and conducts forums with external partners and organizations that cover government entities, corporations, educational institutions, financial institutions, community based organizations, tax professionals, small business, industry and trade associations. Input from these relationships is highly valued as IRS experience and feedback from partners and customer surveys indicates that taxpayers rely on trusted third parties such as community-based groups, stakeholder groups and practitioners to service their tax needs.

IRS conducts external satisfaction surveys of IRS partners and customers (individual, small business and self-employed taxpayers). The IRS is currently preparing to conduct the SB/SE Practitioner Survey. The IRS conducts customer focus groups and obtains feedback from IRS partners and stakeholders to gauge the level of satisfaction with IRS services and products. In addition, the feedback helps IRS guide the development of new programs and/or program enhancements.

The research and cross-functional input is used to identify compliance, taxpayer burden and IRS workload issues that are appropriate for developing and delivering outreach initiatives. This process results in comprehensive strategic plans, which include operational, and improvement priorities, as well as integrated targeted strategies and products.

Examples of targeted customer strategies and products include:

- The creation of "Centers of Excellence" teams made up of executives, managers and employees. The purpose of the teams is to implement the overall strategies such as the "Where to File" website, a comprehensive education and compliance strategy for barter exchanges, comprehensive strategies for employment taxes, initiatives to encourage restaurants and other establishments to participate in compliance-focused programs, and educational materials designed to help the public recognize and avoid abusive tax schemes.
- The E-Commerce Strategy forms partnerships with key e-commerce organizations to address tax compliance issues in the bartering, auction sites and other business arenas. These partnerships include the distribution of tax guidance to the "users" or members of the associations as well as targeted "self correct" initiatives.
- Non-filers, Underreporters and High Income outreach and outreach efforts are used to provide self-correction opportunities.
- Publications and products were developed to address the tax impact of significant life events. Publications, products and website links were provided to IRS external part-

ners who widely distributed them to taxpayers. These products include:

- From Birth Through Childhood brochure
- Living and Working with Disabilities brochure
- Publication 4128 - Tax Facts About Losing Your Job
- Publication 4141 - Senior Citizens: Did You Know that You Can be Charged Tax on Money You Don't Get?

To complement the high degree of planning and partner/stakeholder interaction in developing programs and products, the IRS places equal value in training its employees to deliver high quality service. The IRS provides its employees with the appropriate tax law, marketing, relationship management and software training to service IRS partners, stakeholders and taxpayers. Specialized training is provided to segments of IRS employees to support certain programs such as Centralized Withholding Agreements, TIP/TRAC and filing season support for R-mail and ETLA. Training is conducted functionally and cross-functionally (i.e. E-file and R-mail) based on the number of functions designated to deliver the service. IRS employee engagement in program and product development is accomplished in several ways. IRS field and headquarters employees are often involved in developing training, products and program deliverables. IRS further capitalizes on the experience of field employees who are delivering the programs (direct and leveraged) by providing various methods (idea sharing sessions, on-line employee feedback, chain of command, and formal Issue Resolution Tracking System) of raising trending program or partner/stakeholder/taxpayer issues and suggestions for action.

Method of Delivery

IRS utilizes a combination of leveraged and direct methods of delivering outreach to W&I and SB/SE customer segments. The IRS experience and feedback from partners and customer surveys indicates that taxpayers rely on trusted third parties such as community-based groups, stakeholder groups and practitioners to service their tax needs. Leveraging our outreach products and messages through third-party channels gives us greater reach that enables us to increase the number of outreach contacts year after year within a finite set of IRS resources. Leveraging outreach also lends credibility to messages as they are being received from what taxpayers believe to be a reliable source. These groups are trusted; they provide accessibility; and they provide critical resources and services. For example, community based organizations provide volunteers, communication, language translation, financial literacy and asset building to support volunteer return preparation and educational outreach services.

There are several ways the IRS assures its messages are unadulterated as they are delivered through partners and stakeholders. The first is in packaging. Our printed materials and multimedia packaged materials (such as CD-ROMs), by their nature prevent partners and stakeholders from distorting our messages. This holds true for nearly all our educational products. Even our curriculum for taxpayer education and volunteer return preparation contains workbooks, instructor/teacher guides, and specific updates to provide further incentives to present them as produced. IRS reinforces the key messages and methods of using our material through relationship management meetings and daily interactions with IRS partners and stakeholders.

IRS has engineered a considerable direct delivery channel using the Internet. In addition to the thousands of pages of content for individual taxpayers, there are pages devoted to IRS partners and a self-help website for non-resident students and scholars. In addition, the IRS contributes approximately 10,000 pages of content that is provided to small businesses through the small business portion of the www.irs.gov website. The content continually expands each year to support filing season efforts and other special emphasis programs from a compliance perspective. Taxpayers value this content because they visit the site over a million times each month, with a steadily increasing trend over the last several years. As the Taxpayer Advocate noted, the IRS consistently receives high ratings for the website. Additionally, IRS has two SB/SE electronic tutorial products that are video-streamed through the website. These educational products are used by over 65,000 visitors per month, and again, they exhibit a steadily increasing trend of viewers.

Partner and customer satisfaction survey results remain high on IRS products and services. For W&I, FY 2004 partner satisfaction survey results reflected an overall satisfaction rate of 4.25 on a scale of 5 points for services and products.

The IRS conducts an annual customer satisfaction survey for SB/SE products and services. The survey results are used to determine what products and services are being used as well as needed improvements. On a scale of 5, IRS continues to receive 4.5 or higher as an overall customer satisfaction rating.

Measurement of Effectiveness

The NTA states that IRS needs to continue to measure the effectiveness of various types of contact with taxpayers. IRS agrees that measuring the impact of outreach on voluntary compliance is a challenge.

The Taxpayer Advocate is correct in that we do not have a systemic way of monitoring stakeholder communications. However, manual spot checks of our stakeholders' communications and partner, stakeholder and customer feedback have been consistently positive regarding the quality of our products and outreach materials in servicing their needs.

While the impact of outreach campaigns on compliance is difficult to measure, the IRS has made progress in identifying cause and effect metrics and methods of measurement. In addition to the example stated in the NTA report, there are several IRS projects that have been measured that demonstrate the effectiveness of outreach programs.

In SB/SE, studies include: 1) internal study on outreach to innocent but fraudulent claims for slavery reparations. The study demonstrated IRS effectiveness in having an impact on taxpayer behavior; 2) a study which demonstrated a measurable impact on an employment tax project (The results showed relative improvements in 5 of the 7 areas measured due to general outreach.); and 3) a study tracking the significant increases in the TIP/TRAC agreements and potential revenue.

In W&I, two multi-year pilots are being conducted around EITC participation dependency (Dependent Database rule), EITC E-file rejects, math error and adjustment issues in 10 territories including 5 field offices addressing the LEP population. The pilots involve comparing multiple tax years of W&I outreach and volunteer return preparation activities. The objectives are to determine the impact of IRS and IRS partner presence and involvement in outreach and return preparation activities on compliance metrics. In addition, we look to gain insight on the most effective ways of delivering outreach.

During FY 2004, the IRS initiated a number of multi-year behavioral and needs assessments qualitative research studies to better understand a particular market segment. For instance, W&I coordinated a needs and products assessment research project for Hispanic Limited-English Proficient taxpayers, working closely with the IRS Multilingual Project Office, the EITC Project Office, Taxpayer Advocate Service, and W&I Research. After receipt of the focus group results, the IRS convened a cross-functional group to develop and implement strategies to address the needs identified through the study. A second study involved focus group interviews with retired military personnel to understand reasons for payment non-compliance once these individuals retired from service. Again, the IRS used the results and convened a cross-functional group including W&I Compliance, and W&I Research to develop and implement education and outreach activities to both improve voluntary compliance and to measure the impact of pre-filing education and outreach to the retired military population.

Jointly, W&I and SB/SE, as part of the e-file marketing campaign to tax preparers in 2004, are going to measure the changes in behavior of tax preparers for which the various types of contact (face-to-face, telephone, mail) were conducted and compare the results to the established control groups to determine the impact on increasing the rate of e-file returns among tax preparers. The IRS will continue its effort to measure outreach effectiveness.

TAXPAYER ADVOCATE SERVICE COMMENTS

The IRS response has identified a significant number of outreach events, publications, and other activities to assist taxpayers. The IRS has apparently misconstrued our comments; we did not intend to imply that the IRS has not implemented any valid and helpful education and outreach programs. Rather, our principal concern is that there is no education and outreach strategy that (1) sets forth identifiable and quantifiable objectives, (2) actively utilizes available sources of research, and (3) provides for a method of measuring the effectiveness of its initiatives.

Certainly, the National Taxpayer Advocate recognizes that the IRS has taken many steps to improve its outreach and education efforts, and commends the IRS for its efforts. We applaud the IRS on its continued efforts to bolster its pre-filing outreach and education initiatives in an environment where enforcement appears to be a high priority. We appreciate the efforts of the IRS to partner with stakeholders in the community to disseminate information, particularly with respect to EITC and small business outreach. We commend the IRS on its use of technology to advance its outreach objectives. We are especially intrigued by education and outreach efforts in industries that have traditionally been fraught with noncompliance, such as the construction and restaurant industries.

However, we are unable to discern an overall strategy to the education and outreach efforts; it appears that the IRS is busy "putting out fires" rather than focusing on a long-term strategy. It is unclear to us how the IRS selects the issues that require education and outreach. We believe that the education and outreach arms of IRS need to be in constant communication with IRS policymakers and program directors to ensure that the objectives and expectations remain aligned. Moreover, SPEC and TEC should not only push information out (in accordance with the IRS strategic plan), but must also pull information in (via research and observation of customer needs). Once this information is "pulled in", it needs to be shared with the appropriate program owners for review and action. Without this two-way communication, there is a real danger that the needs of the W&I and SB/SE taxpayers will not be properly addressed.

For example, one of the IRS' most challenging endeavors is to identify and reduce the so-called "tax gap." A large portion of the tax gap is attributable to underreporting and nonfiling by the self-employed. Therefore, it is imperative that the IRS make it a priority to devise a comprehensive education and outreach strategy to address the alarming rate of non-filing within the self-employed population. The National Taxpayer Advocate recognizes that this is no easy task, but nonetheless feels that the IRS can no longer ignore this issue. (If the lack of activity in this area is due to a resource constraint, we fully support a request for additional education and outreach funding.)

The current measures employed by the IRS in determining the effectiveness of an outreach event fall short of providing the information necessary to understand its customer base and provide specific guidance to the individuals and businesses it serves. For example, while the IRS provides very useful content on its website, is there any follow-up research to determine whether there was accurate comprehension of the intended message? Without a way to measure the effectiveness of an outreach initiative, it is impossible to know whether such an initiative was successful.

PROBLEM

TOPIC B-6 MOST SERIOUS PROBLEM: OVERSIGHT OF UNENROLLED RETURN PREPARERS

RESPONSIBLE OFFICIAL

Mark E. Matthews, Deputy Commissioner, Services and Enforcement

DEFINITION OF PROBLEM

In her 2002 and 2003 Annual Reports to Congress, the National Taxpayer Advocate recommended the establishment of a Federal program to regulate unenrolled tax preparers.[1] In 2004, the United States Senate passed legislation to implement the recommendation presented in the 2002 Annual Report, and a wide variety of practitioner groups and trade organizations have endorsed it.[2]

In its comments on the proposal as published in the 2003 Report, the IRS raised six concerns regarding the proposed registration system. The IRS pointed out that the agency did not have enough data to analyze the need for the program. The IRS also claimed that it had conducted several initiatives to address the problem.[3] Despite these arguments, the National Taxpayer Advocate does not believe that the IRS has made significant progress in researching the issue or developing programs to alleviate the burden imposed on taxpayers by unscrupulous or incompetent unenrolled preparers.

The IRS has a strategic goal to emphasize enforcement against attorneys and accountants who represent wealthy individuals engaging in abusive tax shelters.[4] However, the IRS has not focused its enforcement efforts on those preparers who prepare taxes for the vast majority of the populace. We are concerned that the IRS is not doing enough to protect these taxpayers.

Further, the outsourcing of tax return preparation to non-U.S. persons must be addressed. Taxpayers and the IRS have limited avenues of recourse against foreign preparers who violate domestic tax laws. The IRS should consider revising the regulations under IRC § 7216 to require U.S. preparers to obtain the meaningful consent of their clients before releasing tax return information to any foreign preparers.

[1] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), 216-230. National Taxpayer Advocate, *Annual Report to Congress* Publication 2104 (Rev. 12-2003), 270-301.

[2] H.R. 1528, 108th Cong. § 141 (passed by the Senate on May 19, 2004, and previously included in § 141 of S., 882).

[3] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 296-301.

[4] ABA Tax Section Meeting: Everson Denounces Shelters, Warns Practitioners to Follow Law, Tax Notes Today, 2004 TNT 90-1 (May 10, 2004); TalkPoints: Compliance Initiatives (Rev. March 26, 2004).

ANALYSIS OF PROBLEM

Proposal to Regulate Unenrolled Return Preparers

In her two previous Annual Reports to Congress,[5] the National Taxpayer Advocate recommended that Congress enact a registration, examination, certification, and enforcement program to regulate unenrolled tax return preparers who prepare for compensation more than five Federal tax returns per calendar year. Preparers covered by the proposal would be required to register with the IRS and pay an applicable administrative fee. During their first year of return preparation, registered preparers would be required to pass an initial examination which would test their technical knowledge and competency to prepare returns. In subsequent years, the program would require either an examination or continuing professional education (CPE) to ensure that the registered preparers are informed of significant tax law changes.[6]

The program would be enforced through several mechanisms. The IRS would issue educational notices and warnings, as well as assess and collect penalties on unenrolled return preparers who fail to comply with the program requirements. In addition, taxpayers would play a valuable role in enforcement. The IRS would conduct a public awareness campaign informing taxpayers of the regulatory program and provide taxpayers with two valuable tools: (1) access to an IRS-maintained database of preparers registered and certified under the program and (2) notification by the IRS when the taxpayer's return was prepared by an unenrolled return preparer who is not registered and certified.

For a detailed discussion of the proposed regulatory program, see the National Taxpayer Advocate's 2002 and 2003 Annual Reports to Congress.[7]

Congressional Response to Proposal

The Tax Administration Good Government Act of 2004 (The Good Government Act),[8] as passed by the United States Senate on May 19, 2004 includes a provision dealing with the regulation of tax return preparers. Specifically, § 141 of the legislation would add § 7530 to the Internal Revenue Code, which generally adopts the National Taxpayer Advocate's proposal to register and test unenrolled preparers who prepare for compensation five or more tax returns per taxable year.[9]

---

[5] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), 216-230. National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 270-301.

[6] The proposal initially required mandatory annual examinations. However, based on the experience of the California program, which is discussed below, mandatory annual CPE requirements are also a viable option. Either annual testing or CPE requirements should not pose a significant burden on the preparers. Advances in technology have eased the burden of satisfying CPE requirements and scheduling professional examinations. For example, the recent conversion of the uniform C.P.A. exam to a computer format was greeted with favorable reviews by exam takers, with the main benefit cited as greater flexibility in scheduling exam times and locations. Pilot Test Reveals Dramatic Changes, Journal of Accountancy (Feb. 2004), which can be found at http://www.aicpa.org/pubs/jofa/feb2004/cpaexam.htm

[7] National Taxpayer Advocate, Annual Report to Congress, Publication 2104 (Rev. 12-2002), 216-230, National Taxpayer Advocate, Annual Report to Congress, Publication 2104 (Rev. 12-2003), 270-301.

[8] HR 1528, 108th Cong. § 141 (passed by the Senate on May 19, 2004 and previously included as § 141 of S. 882).

[9] *Id.*

IRS COMMENTS ON THE PROPOSAL

The IRS comments on the proposal as published in the 2003 Annual Report to Congress identified six concerns.

IRS Issue No. 1: Federal vs. State Role

The IRS has raised two issues related to the role of the Federal government in the regulation of tax return preparers: (1) the licensing of professionals has historically been within the authority of state government, and (2) the effectiveness of existing state programs in California and Oregon have not been proven.

Federal Authority to Regulate

The determination of which government jurisdiction has the authority to regulate a particular group of professionals should depend on the body of law governing the field in which those professionals practice. Specifically, it is appropriate for states and localities to regulate professionals practicing in fields subject to bodies of law that vary by state or locality. Similarly, it is wholly appropriate for the Federal government to regulate professionals practicing in a field consisting of Federal law. Accordingly, because the preparation and filing of Federal tax returns are activities governed by a national body of law, the Federal government should regulate Federal tax return preparers.

The enactment of legislation establishing the Federal regulatory program need not pre-empt the state's role in regulating tax return preparers. In the securities industry, broker-dealers are required to register with the Securities and Exchange Commission (SEC), which has delegated the regulation function to the National Association of Securities Dealers, Inc. (NASD). The NASD regulates, on a national level, securities professionals who are also regulated at the state level.[10] Similarly, states and localities would still be at liberty to regulate tax return preparers on their activities related to the preparation and filing of state and local tax returns by setting equivalent or stricter standards.[11]

The IRS stated that the Tax Reform Act of 1976 "explicitly recognized the rights of states and localities to regulate them independent of the Federal government." However, the IRS may be reading more into the 1976 legislation than is warranted. Section 1202 of the Tax Reform Act of 1976 added IRC § 6103(k)(5), which provides that the Federal government may disclose tax return information for tax administrative purposes to a state or

[10] As of October 13, 2004, the Senate Finance Committee announced several amendments to the legislation. U.S. Senate Committee on Finance, News Release: "Baucus and Grassley Release Staff Draft of the Registration of Income Tax Return Preparer Proposal" (Oct.1, 2004).

[11] We note that the Federal government has not shied away from pre-empting state law in other contexts. For example, the Office of the Comptroller of the Currency recently amended its regulations to set forth which types of state laws apply to the activities of national banks and which are pre-empted. In general, state laws are pre-empted if the state laws obstruct, impair or condition a national bank's ability to exercise its federally authorized powers. Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg.1904-01 (Jan. 13, 2004) (to be codified at 12 C.F.R. pts. 7, 34).

local government that regulates return preparers.[12] While IRC § 6103(k)(5) acknowledges the authority of state and local governments to regulate return preparers, the provision merely sets forth the limited circumstances during which a government official may disclose confidential tax return information. It in no way conveys or limits the authority of any governmental unit to regulate any type of activity.[13]

Experience of States in Regulating Tax Return Preparers

The IRS also argued that the existing programs in California and Oregon have not been determined to be successful, noting that California experiences difficulty in identifying unregistered preparers. To the contrary, we have found that the administrators of the California program believe it is successful in decreasing noncompliance. Further, both state programs are self-sustaining in that the fee revenues cover the costs of running the programs. The discussion below summarizes some of the relevant points of each program.[14]

California Regulatory Program

In California, over 34,000 "tax preparers" were registered with the California Tax Education Council (CTEC) in 2004.[15] "Tax preparers" required to register under the program are defined as individuals and business entities that assist or prepare Federal or state tax returns for consideration, with a specific exemption for those licensed as attorneys or CPAs in California, as well as enrolled agents regulated by the IRS.[16]

To register, applicants must post a $5,000 security bond[17] and have undergone initial continuing professional education (CPE) from approved sources.[18] Upon the applicant's completion of the registration requirements and payment of the $25 registration fee, CTEC issues a certificate of completion.[19] The CTEC also assigns each registered preparer a unique registration number and issues an identification card and window sticker to iden-

[12] Pub. L. No. 94-455, § 1202, 90 Stat 1520 (Oct. 4, 1976); IRC § 6103(k)(5).

[13] One basic rule of statutory construction provides that statutory language should be construed in the context of the entire statute. *Gen. Dynamics Land Sys., Inc. v. Cline*, 124 S.Ct. 1236 (2004). While there is a general reluctance among courts to interpret any Federal statute to interfere with state tax administration, this principle is inapplicable here. Federal oversight of return preparers applies to the preparation of Federal returns as opposed to state returns. *Nat'l Private Truck Council, Inc. v. Oklahoma Tax Comm'n*, 515 U.S. 582 (1995).

[14] Westchester County, New York recently enacted legislation to regulate income tax preparers. See http://www.westchester.com/Westchester_News/Westchester_Government_26_Politics/200409164286.html.

[15] Cal. Bus. & Prof. Code §§ 22251(d), 22253(a)(1). California Tax Education Council, *2002-2003 Annual Report*, 4-5. The number of registrations has increased from approximately 28,000 in 1997, the year of the program inception. Letter from Celeste Heritage, Vice President, Advocation, Inc. to the Taxpayer Advocate Service (July 21, 2004).

[16] Cal. Bus. & Prof. Code §§ 22251(a)(1), 22258.

[17] Cal. Bus. & Prof. Code § 22250.

[18] To register, the program requires 60 hours of CPE within the previous 18 months, with 45 hours covering federal taxation and 15 on state taxation. Cal. Bus. & Prof. Code § 22255.

[19] Cal. Bus. & Prof. Code § 22255(a).

tify the preparer as registered with the CTEC.[20] To maintain their status, tax preparers must pay an annual $25 registration fee and complete 20 hours of CPE.[21]

If preparers fail to abide by the program's standards and procedures, the following statutory methods of enforcement are available: (1) injunctions, (2) fines or imprisonment, and (3) civil rights of action.[22] In addition, the CTEC claims that the following nonstatutory methods of enforcement have played an important role in reducing the number of noncompliant preparers:

- *The public awareness campaign conducted by the CTEC is believed to be the single most effective tool to prevent preparers from going underground in California. The campaign informs taxpayers of the importance of obtaining the preparer's signature on tax returns.*[23]
- The CTEC website provides a database of registered tax preparers. The public can access the database to check the status of preparers and report suspect preparers to the CTEC.[24]
- Since 2003, the CTEC has collaborated with the California Franchise Tax Board (FTB) by funding increased FTB field visits to check on preparer registration status. The FTB reports the findings from these visits to the CTEC.[25]

Since the inception of the program, the CTEC has contracted the administration of the entire regulatory program to an outside company. In addition, the program has never received state funding because it has always been self-funded through registration fees.[26]

Oregon Regulatory of Return Preparers

The Oregon State Board of Tax Preparers ("the Board") regulates "tax preparers," a designation which includes both unenrolled preparers and enrolled agents who prepare personal income tax returns for a fee.[27] The Board is funded entirely by the fees collected from examinations, licenses and civil penalties assessed for violation of the rules.[28]

[20] The CTEC website provides a searchable database which allows the public to determine whether a certain preparer is properly registered. Available at http://www.ctec.org/verify.asp.

[21] The annual CPE requirement of 20 hours consists of 12 hours of federal taxation, four hours of state taxation, and four hours of either state or federal taxation. Cal. Bus. & Prof. Code § 22255.

[22] Cal. Bus. & Prof. Code §§ 22256, 22257.

[23] CTEC, *2002-2003 Annual Report*, 6-9; Telephone Conversation with Celeste H. Heritage, Vice President Advocation Inc. (July 16, 2004).

[24] *Id.*

[25] During the first quarter of 2003, the FTB made approximately 170 visits to tax preparation offices throughout the state and found that approximately 15 percent were improperly unregistered. The FTB provides those names to the CTEC, which orders the preparers to "cease and desist" preparing taxes for a fee until they register. One-third of the unregistered preparers subsequently became registered. The rest were notified of the law and the possibility of prosecution. CTEC, *2002-2003 Annual Report*, 6-7.

[26] Letter from Celeste Heritage, Vice President, Advocation, Inc. to the Taxpayer Advocate Service (July 21, 2004).

[27] CPAs and attorneys licensed to practice in Oregon are exempt from the regulatory program. Or. Rev. Stat. §§ 673.610, -.615, -.725.

Oregon issues two types of licenses: (1) a tax preparer license and (2) a tax consultant license. A licensed tax preparer must work under the supervision of a licensed tax consultant.[29] Both types of licenses require the individual to pass a Board-administered exam and satisfy mandatory education requirements, with the tax consultant requirements more comprehensive than those applicable to tax preparers.[30] Both tax preparers and consultants must pay an annual renewal fee and complete 30 hours of Board-approved CPE.[31]

The Oregon Department of Revenue has the authority to furnish the names of preparers to the Board,[32] which is empowered to discipline licensed tax preparers and consultants in the following manner: (1) deny issuance of, suspend or revoke a license; (2) reprimand the practitioner; (3) issue a "cease and desist" order and (4) assess civil penalties.[33]

IRS Issue No. 2: Public Perception

The IRS stated that "many taxpayers may incorrectly view the registration of a tax preparer by the IRS as an endorsement by the agency and mislead them into thinking that they will get better service and somehow have recourse to the IRS should their 'certified' preparers make errors or take advantage of the taxpayer."[34]

The National Taxpayer Advocate takes the position that taxpayers' views on the fairness of the tax system are largely shaped by the totality of their experiences interacting with the system. Integral to their views on fairness are their experiences with their return preparers. If the IRS does not police the return preparation and filing profession, taxpayers are more likely to have bad experiences with unscrupulous or incompetent preparers, which will unquestionably taint their resulting impression of the tax system.

The same risk of perceived IRS endorsement also applies to administration of the enrolled agent and authorized IRS e-file Provider programs. In the electronic filing arena, the IRS maintains oversight authority over authorized IRS e-file providers by approving applications and imposing sanctions when necessary.[35] Despite the risk of perceived endorsement, the IRS continues to administer the program, presumably to encourage taxpayers to electronically file. The IRS even helps taxpayers locate authorized e-file providers by providing the e-file Provider Locator on the IRS official website.[36] Further,

[28] The licensing fees are very reasonable in amount, with the examination, initial license and annual renewal fees well under $100 each for both tax preparers and tax consultants. Or. Rev. Stat. §§ 673.685, -.730; *See also* http://www.open.org/~ortaxbrd/GENINFO.htm.

[29] Or. Rev. Stat. § 673.615.

[30] Or. Rev. Stat. §§ 673.625., -.637.

[31] Or. Rev. Stat. § 673.655.

[32] Or. Rev. Stat. § 673.710.

[33] Or. Rev. Stat. §§ 673.700, -.730.

[34] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 298.

[35] *See* IRS Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*; Rev. Proc. 2000-31, 2000-2 C.B. 146, 2000-31 I.R.B. 146 (July 14, 2000).

[36] Available at http://www.irs.gov/efile/page/0,,id=10162,00.html.

the IRS publishes a list of exemplary ERO award recipients on its official website.[37]

IRS Issue No. 3: Resources

The IRS maintains that, "the IRS does not have sufficient current resources to administer a federal regulation of tax preparers program." The IRS further states that "we can make some assumptions on the scope of resources that would be required by looking at existing procedures that govern practice before the IRS as well as other areas that require high volume processing of information." In addition, the IRS states that "assuming the program for regulation of return preparers has at least the same if not more processing and monitoring requirements … significant additional resources would be required."[38]

The Congressional Budget Office (CBO) has estimated that the implementation of the program as set forth in the Good Government Act[39] would cost $25 million over the first two years of implementation. Afterwards, it is expected that the program will be self-sustaining through user fees.[40] This revenue estimate does not reflect the significant cost savings that would result from greater accuracy. Such a program would improve the accuracy of returns on the front end, and as a result, reduce future compliance costs on the part of both the IRS and taxpayers.[41]

The IRS has devoted resources to the VITA (Volunteer Income Tax Assistance) Link & Learn Taxes program, which is an online training and certification package for VITA volunteers.[42] If the IRS is willing to devote resources to improve the quality of tax preparation by volunteers, it should be equally willing to devote resources necessary to improve the quality of tax preparation by paid preparers.[43]

A possible way to build in administrative efficiencies would be to coordinate the examination requirement with the enrolled agent exam, the Special Enrollment Examination (SEE).[44] Thus, registered preparers could take a relevant portion of the SEE, along with a

[37] Available at http://www.irs.gov/efile/article/0,,id=97952,00.html.

[38] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 298.

[39] H.R. 1528, 108th Cong. § 141 (passed by the Senate on May 19, 2004, and previously included as § 141 of S. 882).

[40] Congressional Budget Office, Cost Estimate, S.882, The Tax Administration Good Government Act of 2004, as Reported by the Senate Committee on Finance on May 4, 2004, and passed by the Senate (as H.R. 1528) on May 19, 2004.

[41] Letter from Sen. Charles E. Grassley and Sen. Max Baucus to Andrew Card, White House Chief of Staff (July 8, 2004), in Tax Notes Today, TNT 136-19 (July 15, 2004); see *also* Letter from Sen. Charles E. Grassley and Sen. Max Baucus to Sec. John Snow, Treas. Dept. (March 31, 2004), in Tax Notes Today, 2004 TNT 63-17 (April 1, 2004).

[42] SPEC's Volunteer Educational Products and Services.

[43] IRS records indicate that approximately 55.7 percent of Form 1040 returns were prepared by paid preparers in Tax Year 2002 while only approximately 0.7 percent were prepared by volunteer organizations. IRS Compliance Data Warehouse, Individual Return Transaction File Data, Tax Year 2002.

[44] The SEE is currently administered by the IRS Office of Professional Responsibility. However, the program has been identified by the IRS as a commercial activity to undergo a competitive sourcing study to give government, private industry and public reimbursable sources the opportunity to compete for the work pursuant to the Office of Management and Budget (OMB) Circular A-76. IRS Office of Procurement, Competitive Sourcing Acquisition Branch (Oct. 26, 2004).

separate ethics component. Such coordination of exams would have the added benefit of placing registered preparers on the track to becoming enrolled agents, if they so choose.

Further, the administration of a CPE requirement appears economically feasible based on the experience of the California regulatory program. As in California, the IRS could consider contracting out the administration functions to a private company. Tax education provider fees and registration fees could fund the program.[45]

The IRS should also look to the experience of the National Association of Securities Dealers, Inc. (NASD), which administers a regulatory program in the securities industry. Professionals must pass mainly computerized examinations and satisfy CPE requirements. The NASD also provides education, writes rules governing behavior, examines member firms for compliance, disciplines noncompliant professionals and maintains BrokerCheck, a publicly accessible database which provides the background of any registered professional.[46]

IRS Issue No. 4: Opportunity Costs

The IRS stated that "the IRS would be faced with redeploying resources from other programs which could have a negative impact on current enforcement, service improvement and revenue collections efforts."[47] The National Taxpayer Advocate believes that the proposed regulatory program would be primarily self-enforcing. Specifically, the program would entail a public awareness campaign, the establishment of a publicly accessible list of registered and certified preparers, and the notification of taxpayers whose returns are prepared by noncompliant unenrolled preparers. Because of measures, the customer base of those unenrolled preparers who fail to properly register and certify will greatly diminish, without any action by IRS enforcement employees.

The IRS has also failed to recognize that the proposed program should have a beneficial impact on all aspects of return preparer compliance. These benefits include a decrease in the use of unskilled or unscrupulous preparers by taxpayers which will lead to fewer errors and adjustments attributable to preparer negligence or fraud. As a result, taxpayers should file more accurate income tax returns and improve overall compliance. Further, as preparers are better informed about the provisions of IRC § 7216, there will be fewer confidentiality and disclosure violations. Consequently, fewer resources will be required

[45] Letter from Celeste Heritage, Vice President, Advocation, Inc. to the IRS Taxpayer Advocate Service (July 21, 2004). CTEC charges providers a fee for curriculum review. California Tax Education Council, *2002-2003 Annual Report*, 7, 16-17.

[46] The Division of Market Regulation of the SEC closely monitors the private sector regulation by the NASD. SEC, Division of Market Regulation, Compliance Guide to the Registration and Regulation of Brokers and Dealers (Oct. 1998), § III.C. For a corporate description of the NASD, see the NASD official website at http://www.nasd.com/corp_info/corp_description.asp. For general information on the role of the NASD, see NASD Registered Representatives & Other Securities Industry Professionals: Testing/ Training – Roles & Responsibilities, at http://www.nasdr.com/reg_rep/default.asp.

[47] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 298.

for a variety of compliance programs and will ultimately produce a more efficient and effective tax administration system.

IRS Issue No. 5: Enforcement

The IRS argues that the proposal's absence of civil or criminal penalties for failure to register encourages unenrolled preparers to ignore the regulatory provisions or even to go underground.[48] The National Taxpayer Advocate agrees that this is a serious concern and the proposed program needs enforcement mechanisms "with teeth" to prevent even further noncompliance. Some possible ways to deal with enforcement of this program are listed below:

- **Failure to Register Penalty.** A substantial failure to register penalty should be assessed on and collected from those unenrolled preparers who continue to prepare returns without properly registering. The Good Government Act, which passed the Senate on May 19, 2004, includes a provision for a $500 per return penalty imposed on non-registered preparers.[49]
- **Public Awareness Campaign.** As previously suggested by the National Taxpayer Advocate and as experienced by the California program, an extremely effective way to prevent preparers from going underground is to conduct outreach to the general taxpayer population, informing them of the risks associated with using preparers who fail to sign their returns. The public awareness campaign would direct taxpayers to an IRS-maintained list of registered preparers to check on preparers' qualifications. The existence of another IRS-maintained list of electronic return originators (EROs) should not unnecessarily confuse taxpayers. Even though the lists may overlap, the IRS's public awareness campaign should guide taxpayers to the appropriate lists.
- **Universal Preparer Registration.** The IRS could issue a universal Federal tax return preparer card or Federal tax return preparer identification number to all categories of preparers, including attorneys, CPAs, enrolled agents and registered and certified preparers. In conjunction with this initiative, the IRS could conduct a public awareness campaign informing taxpayers to look for this universal card or identification number before retaining a preparer's services. This would simplify the process for taxpayers attempting to choose legitimate paid preparers. As an additional measure, the IRS could maintain a publicly-accessible database of preparers in all four categories.

[48] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 298.

[49] Efforts would still be necessary to counter the temptation of preparers to go underground and to avoid signing the return at all. For those preparers who fail to sign returns, the risk of an assessed $500 per return penalty might not be significant enough to alter noncompliant behavior. Even if the preparer was assessed a penalty based on one return, the IRS would have difficulty tracking down additional unsigned returns prepared by that individual.

While unenrolled preparers would be required to register with the program, attorneys and CPAs would be given the option to register. The additional burden of registration would not be imposed on professionals who are already licensed under other programs, but would be an available option if they choose to receive the benefits of the IRS designation and advertising.[50]

IRS Issue No. 6: Additional Taxpayer Costs

The IRS states that, "the cost of this program would likely be passed on to the taxpayer. This can have an unintended consequence of increasing the cost burden to the taxpayer without providing them any assurance that they are buying better or more accurate return preparation services."[51] The National Taxpayer Advocate respectfully and forcefully disagrees with this statement. For all the reasons stated above – testing, education, ethical training and *effective oversight* - taxpayers will have greater assurance that their preparers have some competency in tax preparation. Moreover, based on the fees charged by Oregon and California for similar programs, the additional costs incurred by practitioners should not be prohibitive, especially if shared equally by all clients of each preparer. The program should also result in improved overall tax compliance with fewer penalties and interest, more accurate returns, and fewer contacts by taxpayers with the IRS. Taxpayers may feel the additional marginal cost is well worth these significant improvements.

IRS INITIATIVES

Research and Information Compilation

The IRS indicated that it needs to determine the scope of the problem before supporting legislation regulating unenrolled preparers.[52] Accordingly, the IRS needs to provide an update on the research it is conducting relative to this issue.

It is our understanding that the IRS is conducting several research initiatives concerning the preparer community, to provide data for future business decisions in terms of resources, enforcement and education priorities. One of the more comprehensive initiatives focuses on preparer accuracy and personal compliance issues.[53] While we commend the IRS for conducting this research, we believe that the IRS should initiate the following additional research to determine the need for the proposed legislation, and provide useful information to design the most effective program:

---

[50] Section 500 of the Agency Practice Act should not bar the IRS from issuing the universal federal tax return preparer card or identification number to licensed attorneys or CPAs. The Act provides that a licensed attorney or CPA may represent a person before the IRS without enrollment upon filing a written declaration, Form 2848, Power of Attorney and Declaration of Representative. However, tax return preparation is not considered representation before the IRS for purposes of the Agency Practice Act. Treas. Circular 230, 31 C.F.R. §§ 10.0-10.93.

[51] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003,) 299.

[52] *Id.* at 297.

[53] Office of Professional Responsibility to the Taxpayer Advocate Service (Sept. 24, 2004).

- *Types and number of returns prepared by unenrolled preparers (i.e., 1040s with and without EITC claims, 1040As, 1040EZs, etc.).* This information will indicate which taxpayers use the services of unenrolled preparers, which will enable the IRS to estimate the scope of the problem and focus outreach campaigns accordingly.
- *Assessments of preparer penalties broken down by type of preparer.* This information will provide a general picture of the rates of compliance among the four categories (while noting any IRS biases in assessment).
- *Assessments of penalties and interest against taxpayers who use paid preparers broken down by type of preparer and by type of penalty.* This information will indicate the impact on taxpayers based on the type of preparer retained.
- *Adjustments in tax liabilities on returns prepared by paid preparers broken down by type of preparer.* Again, this would allow the IRS to compare the impact on the taxpayers based on the type of preparer. If the data is detailed by return line item, it might also indicate the types of errors made by each type of preparer, for targeted outreach.
- *General Compliance Research.* The IRS should determine whether the assessment and collection of penalties on preparers have a deterrent effect. What penalty amounts or rates are required to have a meaningful impact? Would it be effective to waive assessed penalties upon the successful completion by preparers of remedial education? Are other compliance "touches" effective deterrents?

Civil Enforcement Initiatives

Penalty assertion is the IRS' key enforcement vehicle for noncompliance among preparers.[54] The Small Business/Self Employed Operating Division (SB/SE) is responsible for assessing and collecting monetary penalties against noncompliant paid preparers. Of the $1.6 million in IRC § 6694 and 6695 penalties assessed (net of abatements) in FY 2001 through FY 2004, SB/SE only collected approximately 33 percent ($516,898). In fact, the rate of collection has been decreasing since FY 2001, with approximate rates of 39 percent in 2001, 31 percent in FY 2002, 28 percent in FY 2003, and 31 percent in FY 2004.[55] The collection of low dollar paid preparer penalties has not been a priority in the division's overall collection efforts due to other higher priority work, such as abusive tax schemes.[56]

However small the monetary amounts of these penalties seem relative to the IRS' other compliance efforts, they may be an effective deterrent to problematic paid preparers. As

[54] IRM 4.10.6.8.2 Return Preparer Penalties. The civil penalties and rights of action are set forth in IRC: §§ 6694, 6695, 6713, 7407, and 7408. Criminal penalties will be discussed below. For a detailed discussion of civil and criminal penalties applicable to return preparers and the National Taxpayer Advocate's legislative proposals with respect to the penalties, see National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 270-301.

[55] In FY 2001, the IRS collected $235,767 of the $605,685 net preparer penalties assessed. In FY 2002, the IRS collected $130,967 of the $425,890 net penalties assessed. In 2003, the IRS collected $92,732 of the $329,198 net penalties assessed. In FY 2004, the IRS collected $57,432 of the $185,550 net penalties assessed. ERIS Preparer Penalty Data as of Sept. 2004.

mentioned earlier, IRS has no data tracking the extent of the problems with paid preparers or how effective its enforcement efforts are in deterring noncompliance. In assessing but not collecting these penalties, the IRS may be sending preparers a mixed message about whether it will tolerate poor performance.

SB/SE also conducts e-file monitoring visits annually on approximately one percent of all EROs, which are identified by referrals, follow-up visits, random selection or targeted selection. For FY 2004, 1,254 visits were conducted. Of the 238 follow-up visits, 21 percent of the EROs received either suspensions or reprimands and 18 percent received warnings.[57]

In an effort to enforce the due diligence penalty under IRC § 6695(g), SB/SE agreed to conduct 241 due diligence visits as part of FY 2004 EITC preparer strategy. However, due to resource constraints, only 180 visits took place, with 29 preparers (16 percent of the 180) assessed penalties.[58]

The IRS is developing a strategy to address the role paid preparers play in the high rate of the erroneous Earned Income Tax Credit (EITC) claims. One initiative includes the prioritization of both the assessment and collection of preparer penalties against preparers of EITC returns.[59] We believe this planned initiative is a step in the right direction and should be expanded to cover more than just preparers of EITC returns.

In addition to the traditional audits and penalty assertions against preparers, it is our understanding that the IRS conducts education and outreach campaigns to the preparer community. We commend their activities and support their continuance. However, we suggest that the IRS must first determine the scope of the problem within the unenrolled preparer community and conduct research to better understand the most effective deterrents to noncompliance.

Criminal Preparer Penalty Enforcement Activities

The IRS Criminal Investigation Division (CI) investigates and enforces criminal sanctions against preparers.[60] CI has two programs to enhance compliance in the return preparer community: (1) the Return Preparer Program (RPP) and (2) the Questionable Refund Program (QRP).

RPP identifies, investigates and prosecutes return preparers who prepare fraudulent and abusive tax returns.[61] CI has stated that the program actually identifies many more poten-

[56] SB/SE Priorities: Preventing Use and Promotion of Abusive Tax Noncompliance, MS-PowerPoint Presentation, slide 3 (Rev. Aug. 12, 2004); General Accounting Office, *Most Taxpayers Believe they benefit from Paid Tax Preparers, but Oversight for IRS is a Challenge*, GAO 04-07, 16 (Oct. 2003).

[57] Minutes, EITC Preparer Strategy FY 2005 / FY 2006 Meeting (July 13-14, 2004).

[58] *Id.*

[59] *Id.*

[60] For a detailed discussion of criminal penalties applicable to return preparers and the National Taxpayer Advocate's related legislative proposals, see National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 270-301.

[61] Response Provided by Criminal Investigation to Taxpayer Advocate Service Information Request, 3 (Nov. 2, 2004).

tially noncompliant preparers than CI actually investigates.[62] The following table summarizes the status of RPP cases between FY 2002 and FY 2004.

TABLE 1.6.1, STATUS OF RPP INVESTIGATIONS: FY 2002 THROUGH FY 2004[63]

RIP Investigations	2002	2003	2004[64]
Initiations	254	229	206
Recommendations	89	169	167
Indictments	61	109	121
Convictions	64	67	117
Sentenced	76	49	90

The data indicates a general decrease in the number of RPP investigations initiated during the past three fiscal years, but there also appears to be an upward trend in the number of RPP cases leading to indictments, convictions and sentencing.[65] The increase in RPP indictments and convictions is probably associated with cases initiated in prior periods, due to the long time lag between the initiation of a case and its ultimate disposition. The current downtrend in initiations could result in a corresponding downtrend in indictments and convictions in the future.

The Questionable Refund Program (QRP) was designed to identify fraudulent returns, stop the payment of fraudulent refunds and refer potential fraudulent schemes to CI field offices. QRP identifies preparers who have prepared questionable refund returns and provides support to the Wage & Investment Operating Division (W&I) to address EITC return preparer compliance issues and to reduce EITC refund fraud.[66]

The QRP data does not isolate cases involving preparers. However, like the RPP data, it appears to show a clear downward trend in QRP investigations initiated between FY 2002 and FY 2004. As with RPP, this current downtrend in case initiations may result in a corresponding downtrend in indictments and convictions in future periods.[67]

[62] Minutes, EITC Preparer Strategy FY 2005 / FY 2006 Meeting (July 13-14, 2004).

[63] Because actions on specific investigations may cross fiscal years, the data does not track cases as they progress through the system. Thus, cases reflected in the data for the Initiations category may not necessarily be reflected in the data for any of the other four categories. Response Provided by Criminal Investigation to Taxpayer Advocate Service Information Request, 1 (Nov. 2, 2004).

[64] As of September 30, 2004, CI had an inventory of 310 open RPP investigations with an additional 257 cases referred for prosecution without final adjudication. Response Provided by Criminal Investigation to Taxpayer Advocate Service Information Request, 1 (Nov. 2, 2004).

[65] Response Provided by Criminal Investigation to Taxpayer Advocate Service Information Request, 1 (Nov. 2, 2004).

[66] Criminal Investigation, Strategy & Program Plan, FY 2004 through FY 2005, 12 (Sept. 15, 2003); http://www.irs.gov/irs/article/0,,id=117528,00.html.

[67] Response Provided by Criminal Investigation to Taxpayer Advocate Service Information Request, 1 (Nov. 2, 2004).

CI contracted econometric studies to empirically test the measurable effects of their activities on voluntary compliance. The findings of the studies will assist CI to measure the effect of various CI activities on voluntary compliance.[68] We commend CI for directing resources to these research initiatives. We also encourage CI to avail itself of the existing body of literature on the indirect effects of criminal enforcement on voluntary compliance.[69]

OUTSOURCING OF TAX PREPARATION SERVICES

It has been estimated that U.S. tax return preparers outsourced more than 100,000 Federal and state returns to foreign preparers in the 2004 filing season.[70] The outsourcing of return preparation gives rise to concerns about taxpayer privacy, supervision of foreign preparers by domestic preparers, and IRS oversight of these arrangements.

Under existing law, both the taxpayers and the IRS would face practical difficulties seeking recourse against foreign preparers who violate tax laws and have no assets in the United States.[71] It is also unclear whether the IRS can impose penalties against the U.S. preparer for violations committed by the foreign preparer based on the agency relationship between the two preparers.[72] General contract principles provide an avenue for the taxpayer to seek relief against the U.S. preparer, but results may vary depending on state law.[73]

As currently drafted, IRC § 7216 and the regulations thereunder are ambiguous concerning whether a U.S. preparer is permitted to outsource returns to a third party foreign

[68] Criminal Investigation, *Strategy & Program Plan, FY 2004 through FY 2005, 3* (Sept. 15, 2003).

[69] IRS, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement*, and *IRS Responsiveness*, Publication 1916 (Rev. 11-96); Karyl A. Kinsey, Deterrence and Alienation Effects of IRS Enforcement: An Analysis of Survey Data, in Why People Pay Taxes: Tax Compliance and Enforcement, 259-285 (Joel Slemrod ed., 1995); Steven Klepper and Daniel Nagin, The Criminal Deterrence Literature: Implications for Research on Taxpayer Compliance, in 2 Taxpayer Compliance: Social Science Perspectives, 126-155 (Keith Hawkins & John M Thomas eds., 1989).

[70] *See* Kenneth A. Gary, *CPAs Concerned with AICPA Stance on Outsourcing Tax Return Preparation*, Tax Notes (Feb. 26, 2004).

[71] Treas. Reg. § 301.7216-1(b)(2) defines a "tax return preparer" to include an entity that is paid to prepare or assist in preparing a return. Thus, the IRS could assess penalties against the foreign preparer. However, the collection of the penalties might be difficult.

[72] Presumably, if the U.S. preparer actually signs the return, it appears that the IRS can hold the U.S. preparer accountable for any errors caused by the foreign preparer, because the preparer signing the return is responsible for its content and accuracy. Treas. Reg. § 1.6695-1(b); Signature line of Form 1040. It is not clear whether the U.S. preparer is liable in the case where the foreign preparer signs the return or where the foreign preparer's violation of the tax law does not result in an error appearing on the face of the return, such as an IRC § 7216 violation.

[73] While the taxpayer client would have difficulties seeking recourse against the offshore preparer, according to a general principle of contracts law, the domestic tax return preparer should still remain liable to the client for any wrongdoings of its delegatee. Although generally a matter of state law, see § 318(3) of the Restatements (Second) of Contracts ("Unless the obligee agrees otherwise, neither delegation of performance nor a contract to assume the duty made with the obligor by the person delegated discharges any duty or liability of the delegating obligor.").

preparer without first obtaining the taxpayer's meaningful written consent. IRC § 7216 imposes criminal penalties on tax return preparers for improperly disclosing tax return information. However, Treasury Regulation § 301.7216-2(h) provides that a tax return preparer need not secure the client's consent to disclose tax return information to a "tax return processor."[74] Further, Treasury Regulation § 301.7216-2(i) provides that the tax preparer may disclose tax return information without the taxpayer's consent to an officer, employee or member of the preparer.

The regulations under IRC §7216 are not clear with respect to the situation where a U.S. preparer outsources the preparation of the return to a foreign preparer that is not an officer, employee or member of the U.S. preparer. It appears that the "tax return processor" exception applies where the third party foreign tax return preparer merely provides auxiliary services such as the compilation of data and basic math computations. However, does the "tax return processor" exception apply to those outsourcing arrangements where the foreign preparers are given the authority to make substantive tax determinations? The Internal Revenue Code and the Treasury Regulations do not provide needed guidance on this issue.[75]

The definition of "tax return processors" should exclude foreign preparers that make substantive tax law determinations. Those foreign preparers should be subject to the same standards as the U.S. preparers and should be required to register in accordance with the National Taxpayer Advocate's proposal. Unless taxpayers can hold U.S. preparers accountable for any wrongdoing committed by the foreign preparer, the IRS should have oversight authority over them to ensure that they are competent and comply with the tax laws.

While outsourcing return preparation may not currently affect a large percentage of the taxpayer population, it is a matter that must be taken seriously. The voluntary compliance aspect of the tax system is at risk if taxpayers believe that their U.S.-based preparers are outsourcing the preparation of their returns and the IRS has little oversight authority over foreign return preparers.[76] At the very least, taxpayers should be informed of and given the opportunity to approve or disapprove an outsourcing arrangement before their tax return information is released to a foreign preparer.

[74] Treas. Reg. § 301.7216-2(h) provides that a "tax return preparer may disclose tax return information of a taxpayer to another tax return preparer [engaged in the business of providing auxiliary services in connection with the preparation of tax return] for the purpose of having the second tax return preparer transfer that information to, and compute the tax liability on, a tax return of such taxpayer by means of electronic, mechanical, or other form of tax return processing service."

[75] Due to the absence of available guidance, the AICPA is considering adopting new ethical standards addressing this issue, which require the following: (1) members must inform clients of the arrangement beforehand, (2) members are held responsible for the work of the foreign preparer and (3) the contractual arrangement between the member and foreign preparer sure ensure the confidentiality of client records. Accounting: AICPA Considering New Ethical Rules on Outsourcing Disclosure, Confidentiality, Daily Tax Report (Aug.12, 2004).

[76] Letter from Mark W. Everson, IRS Commissioner, to Rep. Edward J. Markey (March 19, 2004).

IRS COMMENTS

In general

The IRS continues to share the National Taxpayer Advocate's concern regarding the quality of services provided by paid return preparers and the competency and standards of professional conduct exhibited by all tax practitioners. The IRS continues to view the practitioner community, including unenrolled return preparers, as a key partner in fulfilling our Mission. The IRS has made it clear that it expects tax preparers and practitioners to be "the pillars of our system of taxation, not the architects of its circumvention."[77] Our commitment in this area is specifically reflected in the IRS' Strategic Plan for 2005-2009.

The IRS recognizes a growing interest in return preparer regulation, and that there is an impact on both taxpayers and tax administration from the actions of unscrupulous or incompetent return preparers. What is not yet clear is whether the regulation of return preparers as proposed by the National Taxpayer Advocate will result in improvements that are commensurate with the costs of such a program. The California and Oregon return preparer registration programs are cited as examples of successful regulation. However, we are not aware of any data demonstrating substantial improvements in error and penalty rates in those states since their programs were implemented, nor is there any information in the TAS report on enforcement activities in those states' programs.

The IRS has focused significant resources over the past year aimed at developing and implementing a service wide strategy to improve our coordination and effectiveness in the return preparer/practitioner arena. The development of this strategy reflects the IRS's commitment to examining and improving both our service and enforcement processes in this critical area.

The IRS agrees that all taxpayers should be able to receive accurate return preparation assistance along with complete confidence that their confidential information is fully protected and accessible by only those individuals as defined by law. The IRS also agrees that preparers who violate this public trust should be identified and subjected to the full range of sanctions available, both civil and criminal.

These comments are intended to further illustrate some of our additional and ongoing efforts in this area and clarify others.

IRS initiatives

The TAS report acknowledges the IRS's strategic goal to emphasize enforcement against attorneys and accountants who represent wealthy individuals engaging in abusive tax shel-

[77] Nomination of Mark W. Everson to be Commissioner of Internal Revenue Service, Department of the Treasury, Hearing Before the Senate Committee on Finance, (March 18, 2003) (statement of Mark W. Everson).

ters. The report suggests, however, that *"the IRS has not focused its enforcement efforts on those preparers who prepare taxes for the vast majority of the populace."*

Notwithstanding the Advocate's statement, the IRS is focusing substantial resources, in terms of enforcement as well as education and outreach, on the paid return preparers who assist the vast majority of taxpayers to comply with the tax laws. In November 2003, the IRS established a working group comprised of senior representatives of every IRS organization that deals with return preparer/practitioner issues. The group evaluated practitioner behaviors, existing tools for deterring or encouraging behaviors, and the coordination thereof. The group identified approximately 68 action items to improve internal coordination and effectiveness in the preparer/practitioner arena, including unenrolled return preparer issues. Although this is a long-term strategy, the IRS has completed work on, or is currently addressing, approximately 86 percent of these items, covering enforcement, education, and information outreach.

- **Enforcement** – In 2003 and 2004, the IRS referred more than 140 individuals to the Department of Justice, requesting that the government obtain injunctions preventing these individuals from further participating in unscrupulous conduct. Many of these individuals are paid return preparers who are preparing false and fraudulent tax returns. Describing these individuals as persons who abuse the American tax system and the trust of their clients, the Department of Justice has vigorously prosecuted these referrals and has been successful in obtaining injunctions against many of the referred individuals. Additionally, paid return preparers are subject to criminal and civil penalties for a wide range of inappropriate behavior.[78] The IRS is pursuing several initiatives with respect to the imposition of these penalties in appropriate cases, including prioritization of preparer penalties for Collection. Further, the Treasury Department and the IRS continue to urge Congress to pass legislation recommended by the Treasury Department in March 2002 that would increase these penalties.
- **Education and Outreach** – During the 2004 filing season, the IRS published guidance warning taxpayers to avoid falling victim to several new and old tax scams and schemes being marketed by unscrupulous preparers and promoters. The IRS intends to publish similar guidance during the 2005 filing season. The IRS also published updates on its webpage (irs.gov) "The Truth About Frivolous Tax Arguments," a document that debunks many of the myths about how taxpayers

[78] Criminal penalties may be asserted for willfully attempting to evade tax, willfully making false statements under penalties of perjury, and willfully aiding, assisting, counseling or advising in the preparation of any document in connection with the Internal Revenue laws that is false or fraudulent. Civil penalties may be asserted for willfully attempting to understate the tax liability of another person, or if the preparer negotiates a check issued with respect to another person's taxes. Preparers are also subject to civil penalties for failing to (1) sign a return, (2) furnish their identifying number, (3) file a correct information return, (4) furnish the taxpayer with a copy of a return, (5) retain a copy of a return, or (6) be diligent in determining a taxpayer's eligibility for the Earned Income Tax Credit.

can legally not file their return or pay their tax obligation. Work also continues on guidance for "Choosing a Return Preparer." Additionally, the IRS continues to expand its return preparer education activities through continuing professional education programs, on-line courses and tax forums. One of the IRS's most effective outreach programs to the tax professional community is the IRS Nationwide Tax Forums. These forums include seminars and trade shows and offer information on tax law changes, ethics, how to save time by e-filing, and how to become an Electronic Return Originator. The IRS also provides materials, through Tax Preparer Institutes, on high priority programs to educational institutions. Additional return preparer material, such as press releases, a toolkit to assist the practitioner community explain the different tax scams and schemes and how to avoid them to their clients, and information on how to report unscrupulous return preparers are available on the IRS webpage (irs.gov).

Several research initiatives have also begun to evaluate a wide range of issues involving the preparer/practitioner community. The research is intended to provide the IRS with data from which future business decisions may be made in terms of resources, enforcement, and education priorities. The primary focus of the most comprehensive initiative is preparer accuracy and compliance related issues. However, this research is still in the preliminary stage. Data from these research initiatives could provide the initial platform to begin to answer some of the questions raised in the TAS report's research recommendations. For example, a comparison of the error and penalty rates for returns from California and Oregon with the rates for other states without preparer registration programs would provide some insight into the impact of those programs on tax administration. Without that data, statements about the success of state regulation of return preparers is based on anecdotes and a "belief" that the public awareness campaign in California is effective in deterring unregistered preparers from going underground.

A Federal return preparer regulation program faces substantial practical impediments to successful implementation. These include:

- development of processes and systems to educate, test and register an unknown number of applicants, variously estimated at several hundred thousand to over one million,
- expansion of the public awareness campaigns regarding return preparers,
- changes to submission processing systems to (among other things) capture data regarding registered preparers from the returns,
- creation of new enforcement processes, including a method for reimbursement of costs incurred by front-line tax administration related to enforcement of the return

preparer registration program if enforcement is to be paid for from registration fees and penalties,

- ensuring that registration and renewal fees cover the full cost of program administration while not creating an excessive financial barrier to entry into the profession, and
- ensuring that the availability of enforcement revenue for program administration costs (as provided for in the most recent version of the legislation) does not create either the appearance or the reality of an incentive to take inappropriate enforcement actions.

The IRS response to previous National Taxpayer Advocate recommendations on return preparer regulation noted that additional research was needed before a determination can be made on the advisability of those recommendations. The IRS has undertaken that research, and discussed the methodology with representatives of the National Taxpayer Advocate as the research was planned. The IRS has also stepped up efforts to educate taxpayers and return preparers, and to use existing authorities more effectively to address abusive practices. These education and enforcement initiatives may have a relatively small impact on the overall problem of incompetent and unscrupulous return preparers, especially given the limited penalties available for paid preparers' failure to sign a return, or for negligent return preparation. However, the National Taxpayer Advocate has offered no empirical evidence that a program of Federal return preparer registration will have an impact on these problems that would be commensurate with the burdens it would impose on the IRS and on the large number of competent and ethical return preparers who provide high quality service to their taxpayer clients. Until that evidence is available, we believe it is not appropriate to support the National Taxpayer Advocate's recommendations.

The Advocate also recommends that consideration be given to revising the regulations under IRC § 7216 to require U.S. preparers to obtain the meaningful consent of their clients before releasing tax return information to any foreign preparers. The IRS and the Treasury Department share the Advocate's concern that return preparers will keep their private information confidential and are committed to ensuring that return preparers honor these expectations. A project to revise the § 7216 regulations is included on the Treasury Department and the IRS' current Guidance Priority List.

TAXPAYER ADVOCATE SERVICE COMMENTS

We commend the IRS for its education and outreach initiatives targeted to both taxpayers and return preparers. In particular, the IRS's campaign to inform taxpayers how to choose a preparer and avoid unscrupulous preparers is very beneficial. Further, the IRS's return preparer education activities are extensive and certainly very valuable to all categories of preparers. Nonetheless, a significant portion of these IRS initiatives focus on preparer-related scams and scandals rather than the basic consumer protection of ensuring the competence of return preparers. The tax forums and CPE programs provide useful information to the preparer community, but it is unclear whether such information reaches a large percentage of the unenrolled return preparer population.[79]

The Office of the Taxpayer Advocate has participated in several meetings of the IRS working group dealing with return preparer/practitioner issues. However, the working group did not devote sufficient attention to the proposal to regulate unenrolled preparers. The group focused mainly on preparers retained by higher income taxpayers and not the vast majority of taxpayers. Further, by identifying approximately 68 action items, the group is taking a band-aid approach rather than dealing with the existing systemic problem head on. Each action item is useful on an individual basis, but as a whole, they will not produce the same benefits that would be gained by a structured program such as the National Taxpayer Advocate's proposal.

The IRS states that it is currently pursuing the prioritization of preparer penalties for Collection. The Office of the Taxpayer Advocate will continue to monitor this initiative as we believe that the collection of net assessed preparer penalties is essential to effective oversight and resulting preparer compliance.

We are pleased that the IRS is researching the compliance of return preparers in general. However, given the large number of unenrolled preparers and their impact on the compliance of a large taxpayer segment, we believe more research should focus on the compliance of the unenrolled preparer community, especially in relation to the other categories of preparers. Further, the IRS states that it plans to research the effectiveness of the regulatory programs in California and Oregon. The results of this research should be extremely useful in determining what components of a system of regulation impact preparer compliance. Such research should be comprehensive, not only looking at statistics but also at taxpayer attitudes and behavior. Moreover, conducting this research is not a prerequisite for acknowledging that regulation of unenrolled return preparers is a necessary step.

The National Taxpayer Advocate has made legislative recommendations about regulation of return preparers in two prior reports. In response to each proposal, the IRS has stated that there is not sufficient data to warrant regulation and its attendant costs. We acknowledge that the implementation of a proposed regulatory program will involve practical impediments. However, since the IRS has failed to ascertain the scope of the existing problem, it cannot determine whether the costs outweigh the antic-

[79] Almost 17,000 tax professionals attended the tax forums in 2003, an increase of about 2,000 from 2002. The exact percentage of attendees who were unenrolled preparers is unclear. IRS News Release, "IRS Tax Forums Planned for this Summer," IR-2004-67 (May 12, 2004).

ipated benefits. Moreover, the IRS cannot blame the National Taxpayer Advocate for its own failure to develop such information. The IRS, after all, controls its own research priorities. Given the wide support for a regulatory program in general,[80] the agency needs to research the problem thoroughly in order to determine how best to administer a registration scheme. In addition, the IRS should include the Office of the Taxpayer Advocate in any associated research and strategic planning. But to deny that regulation of unenrolled return preparers is necessary is to stick one's head in the sand, at the expense of taxpayers.

Finally, the IRS has stated that it hesitates to support the proposed program due to the burdens imposed on both the IRS and unenrolled preparers. However, at the same time, the IRS plans to require testing and certification of some 70,000 volunteer return preparers and perform site observation reviews at random Volunteer Income Tax Preparation (VITA) sites. The IRS appears to be more willing to impose burdens on volunteer tax preparers than paid preparers. Further, the performance of site observation reviews infringes upon the privacy of low income taxpayers that visit these monitored volunteer sites. While the overall goal is quality assurance, it seems inappropriate and unjustified, considering the complete absence of oversight of unenrolled preparers.[81]

RECOMMENDATIONS

The National Taxpayer Advocate believes the IRS should take the following actions with respect to the Regulation of Federal Tax Return Preparers.

- *Research the preparer community to better design an approach to regulating unenrolled preparers. The following data would be useful in this analysis:*
    1. *Types and number of returns prepared by unenrolled preparers;*
    2. *Assessments of preparer penalties broken down by type of preparer;*
    3. *Assessments of penalties and interest against taxpayers who use paid preparers broken down by type of preparer and by type of penalty; and,*
    4. *Adjustments in tax liabilities on returns prepared by paid preparers, broken down by type of preparer (broken down by return line item).*
- *Research the programs in California and Oregon to determine their effectiveness as well as learn from their experiences in administering similar programs. The IRS should also research the regulatory program administered by the National Association of Securities Dealers (NASD).*

[80] For example, see H.R. 1528, 108th Cong. § 141 (passed by the Senate on May 19, 2004 and previously included in § 141 of S. 882); National Association of Tax Professionals Presentation to Taxpayer Advocacy Panel, available at http://www.natptax.com/natptap.pdf; ABA Members Submit Comments on Practitioner Licensing Plan, Tax Notes Today, 2004 TNT 24-19 (Feb. 5 2004); James D. Leimbach, NAEA Supports Full Funding of IRS, Tax Notes Today, 2004 TNT 62-29 (March 31, 2004). In addition, the Office of the Taxpayer Advocate conducted focus groups, attended by all types of preparers, on the issue of regulation of return preparers at each of the 2004 IRS Tax Forums. Attending practitioners differed on certification requirements and administrative issues, but an overwhelming majority of the focus group attendees supported the need to institute some form of regulatory program.

[81] For a more detailed discussion of issues with VITA programs, *see* Problems in Volunteer Return Preparation Program, *infra*.

- *Explore integrating the required initial examination under the proposed program with the SEE (Special Enrollment Examination) of the enrolled agents program. In addition, the IRS should research the feasibility of subsequent periodic examinations or CPE requirements.*
- *Explore the possibility of issuing a universal Federal tax return preparer card or Federal tax return preparer identification number to all categories of preparers, including attorneys, CPAs, enrolled agents and registered and certified preparers.*
- *Prioritize both the assessment and collection of preparer penalties.*
- *Conduct general compliance research to analyze the deterrent effect of the assessment and collection of civil and criminal penalties on preparers.*
- *Revise the regulations under IRC § 7216 to address the outsourcing of tax return preparation services to foreign preparers, who should be subject to the same standards as domestic ones. In addition, domestic preparers should be held accountable for the wrongdoings of the foreign preparers as well as required to obtain the meaningful consent of their clients before releasing tax return information to the foreign preparers.*
- *Include the Office of the Taxpayer Advocate in planning and evaluation of all research initiatives and strategic planning decisions regarding the oversight of tax return preparers.*

PROBLEM

TOPIC B-7 MOST SERIOUS PROBLEM: ELECTRONIC RETURN PREPARATION AND FILING

RESPONSIBLE OFFICIALS

W. Todd Grams, Chief Information Officer
Henry O. Lamar, Jr., Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

In the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Congress directed the IRS to achieve a goal of 80 percent electronic filing (e-filing) by 2007. E-filing enormously benefits both taxpayers and the IRS for a variety of reasons, including faster refunds, reduced errors and lower processing costs.[1] In the 2004 filing season, taxpayers and preparers electronically filed approximately 61 million individual returns out of the total 128 million returns received, or approximately 48 percent.[2]

A number of obstacles prevent taxpayers from electronically preparing or filing their returns. Some of the main issues cited by taxpayers are security, cost, and preparers who do not e-file.[3] To afford more e-file benefits to the taxpayer, the IRS needs to devise an effective strategy to overcome these problems. The IRS must also acknowledge that it will not be able to convert all paper return filers to e-filers, and should plan accordingly to provide these taxpayers with the most optimal filing method.

The IRS has decided to discontinue the TeleFile program after the 2005 filing season due to high costs and low demand. Although the IRS counts tax returns received through TeleFile as electronically filed, research indicates that if the program ends, a significant portion of TeleFilers will revert to paper forms.[4] Further, shutting down the program appears contrary to the express direction of Congress to continue and improve TeleFile.[5]

ANALYSIS OF PROBLEM

Background

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) mandated that the IRS set a goal of having 80 percent of all federal tax returns and information returns filed electronically by 2007.[6] The IRS has since made significant progress toward

[1] Instructions for 2003 Form 1040 (U.S. Individual Income Tax Return), 3.

[2] Internal Revenue Service, "2004 Filing Season Statistics as of August 27, 2004," available at http://www.irs.gov.

[3] Russell Marketing Research, "Findings From the 2003 Wave Of *e-file* Taxpayer & Preparer Satisfaction Research," Presentation at the 2003 IRS Research Integration Meetings, screen 37 (July 2003); University of Arkansas, *The Arkansas Poll, 2003 Summary Report*, available at: http://plsc.uark.edu/arkpoll, 8.

[4] In tax year, 2001, when taxpayers stopped using TeleFile, 55 percent went back to paper and 45 percent used an electronic product. *See* "TeleFile Survey Report," Research Project 1-03-08-2-107N, W&I (Wage & Investment) Research Group 1, screen 43 (Nov. 2003).

[5] *See* H.R. Conf. Rep. No. 105-599 at 235 (1998).

[6] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No.105-206 (1998) (codified at IRC § 6011(f)(1) & (2)). As a way of meeting the e-filing goal the IRS entered into a three-year public private partnership with the Free File Alliance, LLC. The Free File Agreement can be viewed at http://www.irs.gov/efile/article.

this goal by making e-filing easier and creating e-file incentives, including allowing individual taxpayers to:

- electronically sign returns;
- e-file state returns with Federal returns; and
- make payments by credit card.[7]

Types of E-Filing

For calendar year 2004 (through August), approximately 48 percent of individual returns were e-filed.[8] There are three basic types of e-filing:

1. The return is prepared with an online tax preparation software product; preparation or filing may involve a fee. This method also includes the use of the Free File Program, by accessing the member company's software through the official IRS website. Filing through the Free File Program may include a fee for tax preparation or filing.
2. The return is prepared with commercial software on a personal computer or network. Once complete, the return is transmitted electronically to the IRS.
3. The return is filed through the TeleFile program.[9]

Benefits of Electronic Filing

Aside from the goal set by RRA 98, the IRS has a great incentive to promote electronic filing. In fact, the driving force behind the goal established by Congress is that e-filing significantly benefits both taxpayers and the IRS.[10]

For the taxpayer, perhaps the most publicized and appreciated benefit is the quicker turnaround time for refunds. An e-filed return eliminates the mailing and processing time associated with paper filing. The turnaround is even shorter for e-filers who receive refunds by direct deposit.[11]

[7] *See* Internal Revenue Service, "E-file Using a Computer," available at http://www.irs.gov.

[8] Of the approximately 61 million e-filed returns, 42.7 million were prepared by preparers, 14.5 million were self-prepared and 3.7 million were received through TeleFile. *See* Internal Revenue Service "2004 Filing Season Statistics as of August 27, 2004," available at http://www.irs.gov.

[9] The IRS counts returns filed through TeleFile as e-file receipts. TeleFile allows taxpayers to file less complex Federal tax returns (Form 1040-EZ) with IRS seven days a week, 24 hours a day using only a touch-tone telephone. See IRM 3.42.5.20.1 (10-1-2004). In FY 2003, 4,027,000 individuals filed through TeleFile by August 29, 2003. In FY 2004, 3,771,000 individuals filed through Telefile by August 27, 2004. *See* Internal Revenue Service "2004 Filing Season Statistics, Cumulative through the weeks ending 8/29/03 and 8/27/04," available at http://www.irs.gov.

[10] S. Rep. No. 105-174, 39-40 (1998).

[11] A tax refund directly deposited to a bank account from a return that is e-filed can be received in as little as 10 days. *See* p. 56 of the 2003 Instructions for Form 1040. The average e-file refund is issued in 14 days, but can be issued in as little as 10 days. A refund from a paper filed return is issued within approximately four to six weeks. IRS News Release, "IRS Announces Jan. 10 First Day of E-file Season," IR-2003-4 (Jan. 9, 2003).

Taxpayers who e-file also benefit from a reduction in the overall return error rate. E-filing virtually eliminates IRS transcription errors.[12] E-filed returns are also pre-screened to ensure that common errors, such as incorrect Social Security numbers or faulty computations of credits, are fixed *before* the returns are accepted. The ability to interact with IRS systems at the front end of the process, as opposed to creating an error on the back end, saves time and effort for both the taxpayer and IRS. The overall error rate for e-filed returns for tax year 2003 was a mere four percent, while the rate before correction for paper returns was 25.4 percent.[13]

Taxpayers also enjoy more tangible benefits from e-filing. When it receives an e-filed return, the IRS transmits an electronic proof of receipt with a time and date stamp. This proof of receipt provides the taxpayer with peace of mind that the return was received and passed the initial pre-screening.[14]

The IRS benefits from e-filing through reduced costs, because e-filed returns require no transcription and are thus cheaper to process.[15] In fiscal year 2002, a paper return cost $2.59 to process, while an e-filed return cost 62 cents.[16] Further, the reduction of errors on e-filed returns saves an immeasurable amount of IRS compliance resources.

Taxpayers' Attitudes Toward E-File

Through an outside vendor, the IRS conducts yearly customer satisfaction surveys to determine why more taxpayers do not file electronically. According to recent research, 11 percent of individual paper return filers avoided e-filing because of cost, and nine percent were concerned about the lack of privacy and security.[17] The most common reason given was "I like paper filing better than e-filing."[18]

Separately, the University of Arkansas conducted a poll in 2003 that requested opinions on e-filing, among other topics.[19] The results indicated that the IRS must overcome three

[12] *Taxpayer Alert: Choosing a Paid Preparer and the Pitfalls of Charitable Car Donation*: Hearing Before the Senate Finance Committee, 105th Cong. 2 (April 1, 2003) (Statement of Pamela J. Gardiner, Acting Inspector General for Tax Administration, U.S. Treasury).

[13] Figures include Tax Year 2003 returns filed through Sept. 17, 2004. Information provided by W&I Submission Processing (Sept. 27, 2004).

[14] Instructions for Form 1040 (U.S. Individual Income Tax Return), 3.

[15] See "Free Online Electronic Tax Filing Agreement," available at http://www.irs.gov.

[16] IRM Exhibit 3.30, Cost Estimate Reference, Exhibit 3.30.10-39, (Rev.11-01-2003).

[17] Russell Marketing Research, "Findings From the 2003 Wave Of *e-file* Taxpayer & Preparer Satisfaction Research," Presentation at the 2003 IRS Research Integration Meetings, screens 3, 37 (July 2003).

[18] For this item, 44 percent chose this response for practitioner e-file, 29 percent for online filing, and 26 percent for Free File. FCB and Russell Research, "Findings From the 2004 *e-file* Taxpayer Satisfaction Study," Presentation at the 2004 Individual/Practitioner Integration Session Meeting, screen 24 (July 2004).

[19] During October 2003, the Survey Research Center at the University of Arkansas dialed 6,696 randomly selected Arkansas telephone numbers, which yielded 762 completed surveys. Employing guidelines established by the American Association for Public Opinion Research, the poll's cooperation rate was 33 percent (completed surveys as a percentage of all eligible individuals contacted). The survey's margin of error is +/- 3 percent.

main barriers to e-filing: (1) preparers who do not e-file, (2) the habit of using paper returns, and (3) distrust of online security. When paper filers were asked why they chose not to e-file, they responded as set forth in Table 1.7.1:[20]

TABLE 1.7.1, PAPER FILERS' REASONS FOR FILING CHOICE

Response	Percentage
Leave it to the preparer	39
Habit-I've always filed by mail	37
Distrust of computer security	12
Not comfortable with computers	10
Postpone payment of tax due	2
Total	**100**

The Arkansas poll further asked those who chose to file by paper: "What would make you more likely to file electronically?" Table 1.7.2 summarizes the responses:[21]

TABLE 1.7.2, WHAT MIGHT PROMPT PAPER FILERS TO CHANGE

Response	Percentage
I leave it to my CPA or tax preparer (volunteered response)	32
More confidence in computer security	22
Nothing would make me more likely (volunteered response)	18
Free or lower filing cost	11
Better personal computer skills	10
Better access to a computer[22]	7
Total	**100**

A 2003 study of taxpayers' attitudes revealed that approximately 31 percent of individual taxpayers complete their returns on a computer and subsequently print and mail hard copies to the IRS. These taxpayers are called "V-Coders," because their returns are coded with a "V" when the IRS processes them. Converting these taxpayers to e-filing will be an

[20] University of Arkansas, *The Arkansas Poll, 2003 Summary Report*, available at: http://plsc.uark.edu/arkpoll, 8.

[21] *Id.*

[22] The level of e-filing is also impacted by the number of taxpayers not having Internet access. Internet usage is increasing among low income families (with an annual income below $25,000). In 2001, approximately 50 percent of those families used computers and approximately 38 percent had Internet access. *See* Economics and Statistics Administration, Department of Commerce, *A Nation Online: How Americans Are Expanding Their Use of the Internet*, (February 2002), available at: http://www.ntia.doc.gov/ntiahome/dn/. (Most current data located). A related concern is the level of computer literacy within the population. Computer literacy is greatest among individuals born after 1980. For example, in 1997 those ages 3 to 17 had a computer usage rate of approximately 75 percent. Among those over 18, however, computer usage was not as prevalent, approximately 45 percent. Peter A. Morrison, *A Demographic Perspective on Our Nation's Future*, RAND Corporation (2001) at http://www.rand.org. Thus, it should be noted that access to a computer or to the Internet does not necessarily determine whether an individual is an experienced computer user or capable to navigate the internet or tax preparation software products.

important step toward achieving the e-filing goals set by Congress.[23]

During 2002, the Wage & Investment Operating Division (W&I) surveyed V-Coders to quantify and rank the reasons why they prepared electronic returns but then filed on paper. As Table 1.7.3 illustrates, cost and security are the highest barriers to moving this group of taxpayers to e-filing:[24]

TABLE 1.7.3, BARRIERS TO ELECTRONIC FILING FOR V-CODERS

Question 6	Importance		
Please mark the importance of each of the following on your decision NOT to file electronically	Strong	Some	None
I didn't want to pay the cost of filing electronically	51%	22%	27%
I don't trust security or technology of electronic filing	32%	27%	41%
I like seeing my return, signing it and putting it in the mail	30%	31%	39%

Security Concerns

Based on the University of Arkansas poll and IRS research, it is clear that a significant number of taxpayers have concerns about the security of e-filing, which the IRS must attempt to overcome.[25] We have identified two steps that the IRS must take to address this issue: (1) implement all necessary security measures to protect tax data during the entire e-filing process,[26] and (2) conduct outreach programs to alleviate taxpayer and preparer concerns about the security in place.

Income Tax Preparers

Converting tax preparers from paper to e-filing would significantly impact the e-file rate for individual returns. In the 2003 filing season, practitioners prepared more than 30 million individual (Form 1040) returns electronically and submitted them on paper. Because practitioners prepare nearly 60 percent of individual returns and more than 85 percent of business returns, it is clear that preparers are key to the growth and success of e-filing.[27]

[23] It is noteworthy that V-Coders as a group, when compared to other types of individual filers, have been found to have the highest median income at approximately $60,000, and are highly educated (68 percent are college educated). Russell Marketing Research, "Findings From the 2003 Wave Of *e-file* Taxpayer Attitudinal Tracking Study," Presentation at the 2003 IRS Research Integration Meetings, screen 50, (July 2003).

[24] "Survey of Taxpayers Who Self-Prepared and Filed a V-Coded Return," ETA Research Project 1-02-08-3-005, W&I Division, Customer Research Group 1, 10 (Jan. 13, 2003).

[25] In the W& I Survey of V-Coders, 32 percent (2nd highest percentage) of those surveyed felt strongly that a lack of trust in the security of e-filing was a barrier to e-filing for them. *See* "Survey of Taxpayers Who Self-Prepared and Filed a V-Coded Return," ETA Research Project 1-02-08-3-005, W&I Division, Customer Research Group 1, January 13, 2003, p.10. In the Arkansas Poll 12 percent (3rd highest percentage) of those surveyed cited distrust of computer security for their reason for paper filing. *See* University of Arkansas, *The Arkansas Poll, 2003 Summary Report*, available at: http://plsc.uark.edu/arkpoll, 8.

[26] During the 2004 filing season, The IRS reprimanded a provider for the unauthorized accesses by third parties to taxpayer data via online filing software. Response Provided by the Office of Electronic Tax Administration to TAS Information Request, (Oct. 12, 2004).

[27] Electronic Tax Administration Advisory Committee, *Annual Report to Congress*, Publication 3415, 4 (Rev. 6-2003).

One main barrier to e-filing for individual taxpayers is that their preparers choose not to e-file. In the previously referenced Arkansas poll, 39 percent of those surveyed indicated that they did not e-file because they leave the decision up to the preparer.[28] Additionally, in the aforementioned IRS marketing survey, 11 percent of respondents indicated that their preparers did not offer electronic filing.[29] Interestingly, market studies have found that a significant number of practitioners do not offer e-filing services because their clients do not ask for them. In a 2004 IRS study, 31 percent of practitioner V-coders indicated they do not e-file due to a lack of demand.[30]

The IRS could take at least two approaches to increase e-file rates among preparers: (1) mandate e-filing for preparers submitting a predetermined minimum number of returns and (2) strengthen e-file outreach and education for the preparer community.

Mandated Electronic Filing by Preparers

Seven states (Alabama, California, Michigan, Minnesota, Oklahoma, Virginia and Wisconsin) currently mandate e-filing for those who prepare a certain volume of returns. The specified number varies by state, with the lowest threshold being 50 returns and the highest being 250. The results are promising in Minnesota and Oklahoma, where the mandates were in place before 2004. During tax year 2003, Minnesota reported a 21 percent increase in e-filing from the previous year and Oklahoma observed an increase of 19 percent.[31]

Based on data from the Minnesota program, there is evidence that state e-file mandates significantly impact the way practitioners prepare Federal returns. In Minnesota, the Federal standard electronic file rate for preparers preparing 100 or more returns is just over 75 percent, which is considerably higher than the national standard electronic file rate of approximately 54 percent.[32]

An indirect benefit of a Federal e-filing mandate would be that more preparers would come under the Electronic Return Originator (ERO) Suitability Checks. This might aid in tracking unscrupulous preparers.[33]

[28] The University of Arkansas, *The Arkansas Poll, 2003 Summary Report*, available at: http://plsc.uark.edu/arkpoll, 8.

[29] Russell Marketing Research, "Findings From the 2003 Wave Of *e-file* Taxpayer & Preparer Satisfaction Research," Presentation at the 2003 IRS Research Integration Meetings, screen 37 (July 2003).

[30] FCB & Russell Research, Presentation of Findings: Practitioner Business Impact Study, Committed e-filer Users vs. Committed V-Coders, Prepared for the Internal Revenue Service, BMF Integration Meeting, screen 11 (Sept. 2004).

[31] The effectiveness of the mandates in five states (Alabama, California, Michigan, Virginia, and Wisconsin), could not be evaluated because the requirements did not take effect until 2004. *See* Memorandum from Harley T. Duncan, Executive Director of the Federation of Tax Administrators to the Federation of Tax Administrators Board of Trustees, 4, 5 (June 5, 2004).

[32] The Minnesota e-file mandate became effective for tax years beginning after December 31, 2001. For tax years beginning after December 31, 2002, the number of returns triggering the mandate was reduced from 500 to 100. Minn. Stat § 289A.08 (16); State e-File Impact on Federal e-File, ETA Research Project 1-04-08-2-032N, W&I Division, Customer Research Group 1, screen 22 (March 2004).

[33] Suitability checks include (1) an FBI criminal background check, (2) a credit history check, (3) a review of personal and business filing compliance, and (4) whether evidence of disreputable conduct or other facts exist that would reflect adversely on the program. See IRS, *Handbook for Authorized IRS e-file Providers*, Publication 1345, 79 (rev. 1-2001).

Preparer Outreach and Education Initiatives

An additional approach to increasing e-filing among preparers is to strengthen outreach and education initiatives to the preparer community by marketing the benefits of e-filing. The IRS has already undertaken significant outreach to preparers and also provides incentives exclusively to e-file providers.[34]

The Cost of Electronic Filing

Some taxpayers will choose not to e-file as long as it costs more than paper filing. As noted above, 11 percent of respondents in the IRS marketing survey indicated that paper filers avoid e-filing because of cost.[35] Further, a recent IRS study found that 17 percent of practitioner V-Coders do not e-file because the associated software and added costs are too expensive.[36] The IRS developed the Free File Alliance in response to these general concerns.

Free File

On October 30, 2002, the IRS entered into an agreement with the Free File Alliance, LLC, a consortium of companies in the electronic tax preparation and filing industry. The agreement provided for member companies to offer free online tax return preparation and filing services to at least 60 percent of U.S. individual filers. This agreement has a three-year term and is due to expire in 2005.[37]

The IRS responded to concerns and complaints about Free File by taking a few initiatives to improve the program from 2003 to 2004. During the 2003 filing season, taxpayers complained about receiving advertisements linked to specific tax return information. For example, a deduction for mortgage interest might trigger an unsolicited advertisement for mortgage refinancing. The IRS announced that Free File companies worked to eliminate those advertisements,[38] and our informal reviews of the programs indicate those efforts have significantly improved the programs.[39] Because the National Taxpayer Advocate believes that the IRS should not refer taxpayers to tax products which market non-tax related products to taxpayers, we will continue to monitor these activities. The IRS also worked with the Free File Alliance to respond to complaints that some Free File sites did

[34] *See* Treasury Inspector General For Tax Administration, Opportunities Exist to Transition Taxpayers From Submitting Computer-Prepared Tax Returns on Paper to E-Filing, Reference No. 2004-40-076, 4 (March 2004). One example of this outreach is an e-file page on the IRS website designed as a resource center for IRS e-file and e-payment information. *See* http://www.irs.gov/efile/index.html.

[35] Russell Marketing Research, "Findings From the 2003 Wave Of *e-file* Taxpayer & Preparer Satisfaction Research," Presentation at the 2003 IRS Research Integration Meetings, screen 37 (July 2003).

[36] FCB & Russell Research, Presentation of Findings: Practitioner Business Impact Study, Committed e-filer Users vs. Committed V-Coders, Prepared for the Internal Revenue Service, BMF Integration Meeting, screen 11 (Sept. 2004).

[37] *See* "Free Online Electronic Tax Filing Agreement," available at http://www.irs.gov.

[38] IRS News Release, "Free File Opens Second Year; Improvements Detailed," IR 2004-13 (Jan. 22, 2004).

[39] The Office of the Taxpayer Advocate tested the programs available through Free File during the 2004 filing season.

not allow the taxpayer to download, print or save tax return information without paying a fee. This problem was alleviated in the 2004 filing season, and taxpayers can now print their completed returns for free, which is appropriate considering that taxpayers are expected to retain records of their filing information.[40]

Despite the improvements to date, the National Taxpayer Advocate believes that the IRS should not renew the contract with the Free File Alliance.[41] However, if the IRS decides to continue the partnership beyond 2005, it must take into account the following additional concerns, which are discussed in greater detail below:

- The IRS should require the Free File Alliance to work with the states as a group, and not on a state-by-state basis, as a condition of renewing the Free File Alliance Agreement. Accordingly, the IRS should include the Federation of Tax Administrators in any second round of negotiations with the Alliance.
- Free File Alliance members need to improve the disclosure of all preparation and filing costs for Federal and state returns.
- The IRS needs to develop a method of evaluating the success of the Free File Program in converting paper filers to e-file.
- The IRS needs to ensure that the members of the Alliance strictly abide by the limitations on disclosure and use of tax return information as set forth in IRC § 7216.

Partnering With State Tax Administrators

The IRS should partner with state tax administrators to encourage a uniform approach to free electronic filing. At present, the Free File Alliance will generally not work with states that have developed their own software to provide a free method of directly filing state taxes online.[42] The IRS has a vested interest in making free electronic filing available to all taxpayers at both the federal and state levels.[43] The IRS and the states must present a united front to the Alliance and negotiate for both Federal and state interests, because Federal e-filing benefits from state e-filing.

[40] IRS News Release, "Free File Opens Second Year; Improvements Detailed," IR 2004-13 (Jan. 22, 2004). Taxpayer Advocacy Panel, *Free File Record Retention*, TAP 04-005 (Dec. 2, 2003). Similar results were found through the Office of the Taxpayer Advocate testing the programs available through Free File during the 2004 filing season.

[41] As discussed below, the IRS should provide a means for all taxpayers to file their returns at no expense. The electronic filing template would eliminate the need for the Free File program. However, taxpayers would still have the choice to pay for the value-added software offered by private industry.

[42] Memorandum from Harley T. Duncan, Executive Director of the Federation of Tax Administrators to the Federation of Tax Administrators Board of Trustees, 5 (June 5, 2004). See also information presented at the FTA Electronic Filing Symposium, Oklahoma City, OK, May 2004, available at http://www.taxadmin.org. Some states, such as Pennsylvania and Virginia have developed their own electronic filing program, while others such as Alabama and Arizona have contracted with the Free File Alliance to provide electronic filing. Federation of Tax Administrators, "States with Internet Filing," available at: http://www.taxadmin.org. However, California has managed to give its taxpayers both options. Franchise Tax Board Website, List of Free e-file Options, located at http://www.ftb.ca.gov/individuals/efile/allsoftware.html.

[43] As noted above, the IRS benefits from an increase in state e-filing. See "State e-File Impact on Federal e-File," ETA Research Project 1-04-08-2-032N, W&I Division, Customer Research Group 1, screen 22, (March 2004).

Many programs available under Free File do not inform the taxpayer of associated costs until the return is complete, at which point the taxpayer has already expended much time and effort and likely feels compelled just to pay the fee to finish the process. The Office of the Taxpayer Advocate tested the various Free File sites linked through the IRS official website during the 2004 filing season and found that while e-filing the Federal return is free, the state return often carries a cost. To be charged a fee for preparation and filing of the state return at the end of the tax preparation process places an unnecessary and unfair burden on the taxpayer. Most state returns are based on the Federal return and it is easier to prepare both at the same time.[44]

Method to Evaluate Success of Program

The National Taxpayer Advocate, the Taxpayer Advocacy Panel (TAP), and the Treasury Inspector General for Tax Administration (TIGTA) have all expressed concerns that the IRS cannot adequately evaluate whether Free File is meeting its stated objective of increasing e-filing.[45] The IRS must be able to determine whether a taxpayer filing with Free File is a first-time e-filer. However, the IRS has no means of tracking electronically prepared returns filed through the Free File program, and consequently cannot distinguish between taxpayers who e-file for a fee in one year and use Free File in a subsequent year, or who are first-time e-filers using Free File. This information is important because switching from one e-file method to another obviously does not advance the goal of increasing the percentage of taxpayers who e-file. The justification for the Free File program hinges upon whether it has converted paper filers to e-file. Compiling and analyzing comparative data would greatly facilitate this evaluation.

In 2003, the IRS proposed placing an electronic tag on Free File returns to help identify which taxpayers converted from paper to electronic filing due to the availability of the Free File program. The Free File Alliance opposed this initiative and the IRS settled for a far less reliable alternative. Two principal arguments were raised in opposition to the Free File indicator.[46] The first argument, that the indicator would undermine taxpayer privacy, is without merit. If electronically filed returns contained a Free File indicator, the IRS would not obtain any additional information that would lessen taxpayer rights. The IRS already: (1) can distinguish between e-filed and paper returns, (2) knows which Electronic Return Originator (ERO) submits each e-filed return, and (3) can search the fields in e-filed returns to identify high-risk items. The indicator would simply allow the IRS to better evaluate

[44] *See* Taxpayer Advocacy Panel, *Free File Notification of Charges*, TAP 04-005 (Dec. 2, 2003); Taxpayer Advocacy Panel, Free *File – Filing State Returns*, TAP 04-008 (Dec. 2, 2003); Experience of Office of Taxpayer Advocate testing Free File programs.

[45] National Taxpayer Advocate, Report to Congress: Fiscal Year 2004 Objectives, Publication 4054 (Revision 06-2003) 18. *See also* Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure Individual Taxpayers Have an Easy, No-Cost Option to e-file Their Tax Returns*, Reference No. 2003-40-165, 9 (Aug. 2003); Taxpayer Advocacy Panel, Free File- Lack of Feedback, TAP 04-009 (Dec. 2, 2003). For further information on the stated e-filing objective see The Free File Alliance agreement which can be viewed at http://www.irs.gov/efile/article/.

[46] National Taxpayer Advocate, *Report to Congress: Fiscal Year 2005 Objectives*, Publication 4054 (Rev. 06-2004) 20-21.

the Free File program, because returns that are newly converted to e-file would be labeled and thus set apart from other e-filed returns.

The second argument addresses the question of whether the IRS should collect company-specific data. The concern is that competitors could obtain proprietary data from the IRS through a Freedom of Information Act (FOIA) request. However, FOIA contains exemptions for proprietary data, so information found to be proprietary by the IRS or a court would be shielded from disclosure. Further, data can only be obtained under FOIA if the agency receiving the FOIA request maintains the information in a "readily reproducible" form.[47] The IRS has stated that it does not intend to compile company–specific information. Thus, unless the government rejects the companies' claims that the data is proprietary and the IRS can easily reproduce the data, it would not be obtainable under FOIA.

Taxpayer Privacy Concerns

The privacy of confidential taxpayer information should be a paramount concern if the IRS decides to enter into future contract negotiations with the Free File Alliance. Taxpayers may perceive the IRS as promoting cross-marketing when the agency permits members of the Free File Alliance to market their products through programs accessible via the IRS website. If the IRS does not completely eliminate the cross-marketing of products in the Free File program, it must take an active role in ensuring that the members of the Free File Alliance properly safeguard private tax return data when cross-marketing products in the tax preparation process.[48]

Electronic Tax Return Template

Free Filing Option Available to All Taxpayers

Unless taxpayers qualify for the Free File Program, they must pay to file electronically. Taxpayers who use commercial tax preparation software generally pay two fees: the cost of the preparation software and the additional fee to e-file the return. The price of the software is justifiable due to the value added by such products. However, many of those taxpayers are V-Coders who file paper returns to avoid the electronic filing fee.[49] Making free e-filing available to all taxpayers would increase the number of e-filed returns by attracting those V-Coders.[50]

[47] 5 U.S.C. §§ 552(a)(3)(B), (b)(4).

[48] For instance, many RAL products or mortgage refinancing offers are actually provided by affiliates of the authorized IRS e-file provider. Thus, at some point in the process, the e-file provider must either (1) provide the taxpayer with information on the affiliate and invite the taxpayer to initiate contact with the affiliate or (2) disclose taxpayer information to the affiliate, enabling the affiliate to initiate contact with the taxpayer.

[49] Russell Marketing Research, "Findings From the 2003 Wave Of *e-file* Taxpayer Attitudinal Tracking Study," Presentation at the 2003 IRS Research Integration Meetings, screen 50, (July 2003).

[50] IRS surveyed V-Coders for their reasons for not filing electronically. Cost was listed as the highest barrier, 51 percent of those surveyed felt strongly that cost was their greatest barrier to electronic filing. *See* "Survey of Taxpayers Who Self-Prepared and Filed a V-Coded Return," ETA Research Project 1-02-08-3-005, W&I Division, Customer Research Group 1, 10 (Jan. 13, 2003).

The National Taxpayer Advocate believes that the IRS should ensure that all taxpayers have the ability to e-file without cost. Specifically, the IRS should create and maintain an electronic tax return template, accessible through the official IRS website, which would allow taxpayers and practitioners to input tax data. This electronic form would perform basic computations and ideally provide a link to related IRS publications on the website. Once all the data is entered, the taxpayer could electronically transmit the return to the IRS without cost. The template would appeal to taxpayers and preparers who (1) refuse to e-file due to cost and (2) distrust the involvement of third parties in electronic filing.[51]

In conjunction with the template, the IRS should also consider developing a secure system to accept at no charge the electronic transmittal of returns prepared with commercial tax software. This would attract V-Coders who claim they do not e-file due to cost.[52] Further, if the IRS ensures the security of the system and publicizes its safeguards through the media, the system may even attract those V-Coders who refuse to e-file due to security concerns.[53] A system that accepts commercially prepared returns at no charge would reduce filing burden by preventing those individuals and preparers who still use commercial tax preparation software from taking the additional step to enter the tax data into the template.

For a detailed discussion of the National Taxpayer Advocate's proposal to create an electronic tax return template, see the *Key Legislative Recommendation on Electronic Filing*.[54]

International Experience

The IRS can look to other countries for guidance in direct electronic filing. Both Australia and the United Kingdom have Internet filing options for individual taxpayers and tax preparers.

AUSTRAILIA

Australia has a self-assessment tax system similar to that of the United States, which requires each individual to file an annual income tax return. A large proportion (70 -75

[51] The IRS has conducted research that indicates taxpayers would feel more comfortable filing directly with the IRS. Russell Marketing Research, "Findings From Focus Groups Among Taxpayers With Self-Simple Returns," screens 21 and 22 (March 2003). These concerns would be addressed if taxpayers could directly transmit returns through the template.

[52] The portal would greatly benefit those V-Coder low volume preparers who do not e-file due to cost. IRS data shows for Tax Year 2002, that nearly 900,000 paid tax return preparers file individual tax returns. Of these preparers, more than 600,000 filed less than ten individual returns. (These figures only reflect preparers who signed returns and included preparer EINs or SSNs. It is unclear exactly how many of these are V-Coders). IRS Compliance Data Warehouse, Tax Year 2002 IRTF File. However, efforts would be necessary to prevent preparers in general from using the portal to avoid maintaining ERO status.

[53] "Survey of Taxpayers Who Self-Prepared and Filed a V-Coded Return," ETA Research Project 1-02-08-3-005, W&I Division, Customer Research Group 1, January 13, 2003, 10.

[54] *See*, Free Electronic Filing For All Taxpayers, *infra*.

percent) of Australian taxpayers use registered tax agents to prepare and file their returns.[55] The Electronic Lodgment Service (ELS) was initially available to participating tax agents to lodge (file) their clients' returns and other tax forms with the Tax Office electronically, via modem.[56] In the late 1990s, the government expanded the system to allow individuals to prepare their own returns.[57] The Australian Tax Office also provides an online template called "e-tax" for individual taxpayers to electronically file their own returns. E-Tax uses a question and answer format to automatically complete an individual tax return.[58] By 2001, ELS received 80 percent of all business and individual returns filed.[59]

United Kingdom

The United Kingdom (UK) has also experienced success with its online tax filing system. In the UK, far fewer individual taxpayers file tax returns (called self-assessments). About two-thirds of the population is under a final withholding system, whereby the tax withheld from income, such as wages and interest, covers the expected tax liability.[60] No return need be filed to report taxes withheld in this manner. Thus, the population of filers in the UK is mainly composed of the self-employed, investors, and higher-income employees.[61]

The UK Inland Revenue (IR) launched an online form in April 2001 as a free return product for use with the Internet self-assessment.[62] The U.S. software industry has described this initiative as less than successful, based on the claim that the cost per return on the system is £33 (approximately $59) with an acceptance rate of three (3) percent.[63] Inland Revenue does not agree with this assessment. The Inland Revenue reports that its estimated cost per electronic return filed for 2003/2004 was £7.45 (approximately $13).[64] The estimated cost of implementing and maintaining Internet service for self-assessment for years one to three was about £27 million (approximately $48 million). The ongoing support cost is between £3 million and £4 million (approximately $5 million and $7 million) per year. In 2003, over 1.1 million of approximately 8.8 million returns were successfully received from customers using this service. As of August 2004, Inland Revenue was on

[55] Telephone interview with Nigel Bailey, Minister-Counsellor Economic, Australian Embassy, Washington, DC (July 22, 2004).

[56] Australian Tax Office, "About the Electronic Lodgment Service," *available at* http://www.ato.gov.au.

[57] Richard Highfield, "The Electronic Revolution Down Under," Tax Notes Int'l, Sept. 9, 2002, 1291.

[58] Australian Tax Office, "General Information about e-tax," *available at* http://www.ato.gov.au.

[59] Richard Highfield, "The Electronic Revolution Down Under," Tax Notes Int'l, Sept. 9, 2002, 1291.

[60] George Guttman, "Comparing U.K. and U.S. Electronic Tax Filing Systems," Tax Notes Int'l, Aug. 14, 2002, 1023.

[61] Richard Highfield, "The Electronic Revolution Down Under," Tax Notes Int'l, Sept. 9, 2002, 1291.

[62] E-mail from Barry L. Smith, Personal Assistant to the Director, e-Services Programme, Inland Revenue, United Kingdom, (Aug. 5, 2004, 5:28 AM). (on file at the Office of the Taxpayer Advocate, Internal Revenue Service).

[63] Letter from Michael F. Cavanagh, Council for Electronic Revenue Communication Advancement to Nina E. Olson, National Taxpayer Advocate, 7 (Dec.19, 2003).

[64] E-mail from Barry L. Smith, Personal Assistant to the Director, e-Services Programme, Inland Revenue, United Kingdom, (Aug. 5, 2004, 5:28 AM). The cost per paper return is not available for comparison.

track to exceed its 2004 target of receiving 1.49 million returns online. Inland Revenue has a goal of 25 percent of self-assessment returns, or approximately 2.2 million returns, being filed electronically by 2005.[65]

Habitual Paper Filers

IRS studies have shown that a significant portion of the taxpayer population will resist e-filing no matter what initiatives the IRS undertakes.[66] In the quest to increase the e-file rate, the IRS has not adequately focused on providing the most beneficial filing method to these taxpayers.

One possible bridge for taxpayers who are reluctant to file electronically would be to initiate 2-D bar coding on forms. To utilize 2-D bar code technology, a taxpayer or preparer uses software to complete the return. When the return is printed, a horizontal and vertical bar code containing the information (for example, name, social security number, etc.) is imprinted on the paper.[67] The IRS scans the return, captures the data, decodes it and processes the return as if it had been sent electronically.[68] This addresses the need to quickly, accurately, and inexpensively transfer, capture, and store large amounts of paper data.

As of 2002, the most current year for which we have data, 17 states have implemented 2-D bar coding.[69] While bar coding does not convert taxpayers to e-file, it carries significant advantages over paper filing, including: 1) quicker return processing, 2) more accurate tax information recording, 3) savings in processing costs due to the need for fewer employees to input data manually,[70] and 4) no additional cost to taxpayers.[71]

Despite its benefits, the IRS has not availed itself of this technology for individual

---

[65] E-mail from Barry L. Smith, Personal Assistant to the Director, e-Services Programme, Inland Revenue, Inland Revenue, United Kingdom, (Aug. 5, 2004).

[66] The most common reason given in a recent IRS study was "I like paper filing better than e-filing." The percentages for that response were 44 percent when asked about practitioner e-file, 29 percent for online filing, and 26 percent for Free File. *See* FCB and Russell Research, "Findings From the 2004 e-file Taxpayer Satisfaction Study," Presentation at the 2004 Individual/Practitioner Integration Session Meeting, screen 24 (July 2004).

[67] "Schedule K-1 Two Dimensional Bar Coding; Payroll Practitioner Forum," SB/SE TEC, screen 5 (Sept.15, 2003).

[68] "Faster Returns Through Bar Coding," available at http://www.mass.gov/.

[69] As of 2002, the 17 states that have implemented 2-D bar coding were: Alabama, Arizona, Colorado, Delaware, Georgia, Illinois, Indiana, Kentucky, Maryland, Michigan, Missouri, New Hampshire, New Jersey, New Mexico, Oregon, Rhode Island, and Virginia. See Federal Tax Administrators (FTA), *"2-D Barcoding–State Status,"* July 26, 2002, available at http://www.taxadmin.org/fta.

[70] Two examples of the difference in per return processing costs for 2-D bar coded returns versus manually processed returns can be found in the states: 1) As of 2002, it cost Missouri approximately $ .41 per manually processed return and $ .16 per 2-D bar coded return; 2) In Indiana, the cost per manually processed return is between $ .42 and $ 1.00 per return while processing a 2-D bar coded returns costs between $ .06 and $ .09 per return. *See* Federal Tax Administrators (FTA), *"2-D Barcoding–State Status,"* July 26, 2002, available at http://www.taxadmin.org/fta.

[71] Federation of Tax Administrators (FTA), *"Guidance on 2-D Bar Coding in Tax Forms Processing: Frequently Asked Questions,"* 2004v2, July 26, 2004, available at http://www.taxadmin.org/fta.

returns. The reason given for not pursuing 2-D bar coding for individual returns is that promoting this method of paper filing would slow the growth of e-filing.[72]

Telefile

The IRS considers TeleFile a form of e-filing, but has decided to discontinue the service for both individual and business taxpayers after the 2005 filing season due to the high cost of serving a relatively small number of users.[73] The IRS is optimistic that TeleFile taxpayers will migrate to e-filing because of their underlying demographics, e.g., 70 percent are under age 34 and 75 percent have Internet access.[74] However, current research shows that 37 percent of current TeleFile users would go back to paper if the program were eliminated.[75]

If the IRS proceeds with the plan to discontinue the TeleFile program, it must also plan for the inevitable return to paper filing. The 2-D bar coding technology discussed above could give TeleFile users an alternative, allowing them to benefit from the increased accuracy in data capture while the IRS incurs lower processing costs.[76]

The National Taxpayer Advocate is also concerned that the IRS is ignoring the express direction of Congress with respect to the TeleFile program. In the Conference Report to RRA 98, Congress stated, "[T]he conferees also intend that the IRS should continue to offer and improve its TeleFile program and make available a comparable program on the Internet."[77] Given this language, if the IRS believes the TeleFile program is no longer viable, it should clearly and publicly make the case for its discontinuance.

---

[72] The IRS plans to use 2-D bar coding in tax year 2004 only for Schedule K-1 (Form 1065), Partner's Share of Income, Credits, Deductions, etc. and Schedule K-1 (Form 1120S), Shareholder's Share of Income, Credits, Deductions, etc. The IRS also plans to use the technology for Forms 941 and Schedule K-1 (Form 1041), Beneficiary's Share of Income, Credits, Deductions, etc. in the future. Memorandum from Ronald S. Rhodes, Director Customer Account Services, W&I Division, to Arlene G. Kay, Executive Director, Systemic Advocacy, Taxpayer Advocate Service (Sept. 1, 2004); Federation of Tax Administrators, IRS Bar Code and OCR Plans (Aug. 2004).

[73] Specifically, the projected cost savings from eliminating TeleFile is five million dollars with approximately four million Form 1040 filers impacted. *See* "TeleFile Survey Report," Research Project 1-03-08-2-107N, W&I (Wage & Investment) Research Group 1, screen 4 (Nov. 2003). Generally, individual taxpayers are eligible to use TeleFile if they filed a return in the prior year that met the filing requirements for Form 1040EZ and they still satisfy the TeleFile qualifications as set forth in IRM 3.42.5.20.1 (10-1-2004). While this discussion focuses on individual taxpayers filing Form 1040EZ, Telefile also accepts Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return, through TeleFile and Form 941, Employer's Record of Federal Tax Liability. *See* "TeleFile Survey Report," Research Project 1-03-08-2-107N, W&I Research Group 1, November 2003, screen 4.

[74] *See* "TeleFile Survey Report," Research Project 1-03-08-2-107N, W&I Research Group 1, November 2003, Screens 35 and 36.

[75] The four main reasons given for returning to paper filing were: (1) Electronic methods are not as easy or convenient (17 percent) ; (2) Lack of familiarity with electronic filing methods (14 percent); (3) Lack of confidence in Internet security (nine percent); and (4) Lack of access to a computer (nine percent). See FCB & Russell Research, "Findings From the 2004 *e-file* Taxpayer Satisfaction Study," Presentation at the 2004 Individual/Practitioner Integration Session Meeting, screen 20 (July 2004). In tax year, 2001, when taxpayers stopped using TeleFile 55 percent went back to paper and 45 percent used an electronic product. *See* "TeleFile Survey Report," Research Project 1-03-08-2-107N, W&I Research Group 1, Screen 43 (Nov. 2003).

[76] The state taxing agencies have found that 2-D bar coding reduces processing costs and error rates for paper returns. *See* Federation of Tax Administrators (FTA), *"Guidance on 2-D Bar Coding in Tax Forms Processing: Frequently Asked Questions"* (July 26, 2004), available at http://www.taxadmin.org/fta.

IRS COMMENTS

The National Taxpayer Advocate recognized the benefits to taxpayers and the IRS of electronic filing, including quicker refunds, reduced error rates and lower processing costs. The Taxpayer Advocate also recognized improvements to the Free File program. For example, although comments from taxpayers during the 2003 and 2004 filing seasons did not reveal significant concerns (if any) regarding pop-up advertising, in response to advocacy groups, the IRS' requested the Free File Alliance to minimize such advertising. In addition, taxpayers can now print their completed returns for free.

Implement Security Measures to Protect Taxpayer Data

IRS e-file systems meet or exceed all government security standards. IRS continues to work with industry to enable them to constantly improve their security profiles. IRS will provide the ability for IRS e-file program participants, who transmit directly to the Electronic Management System (EMS), to use approved encryption methods for the 2005 and later filing seasons, beginning with the Acceptance Testing System (ATS) in November 2004. For the 2005 filing season, IRS intends to begin discontinuing support of non-encrypted transmissions whether by dedicated or dial-up links on the Public Switched Telephone Network (PSTN) with complete phase out by November 2005.

Mandate Preparers to e-file

Internal Revenue Code § 6011(e) precludes IRS from mandating the filing of income tax and self-employment tax returns for individuals, estates and trusts. Chief Counsel opines that the statute also precludes the IRS from placing return filing mandates on all preparers. Congressional policy in RRA 98, § 2001(a), recognized that taxpayer conversion to e-file should occur without mandates by citing IRC § 6011(e) but not changing that provision (*See* Conference Committee Report, H.R. Conf. Rep. No. 105-599). Congressional policy seems to be changing as evidenced by H.R. 1528, § 105, which includes provisions to mandate electronic filing by both taxpayers and preparers that file five or more returns annually.

Free File–Overview

The current Free File Agreement requires the Free File Alliance to provide free online tax preparation and electronic filing (Free File) services to at least 60 percent of the individual taxpaying population. According to the existing Free File Agreement, the IRS will not compete with industry to provide similar free services.

Taxpayers who qualify for an Alliance member's Free File service can use that online software to prepare and e-file their federal tax returns for free. The software used will be the same software available to paying customers. No later than January 2005, the IRS will engage the Free File Alliance to negotiate a new Free Online Electronic Tax Filing Agreement (Free File Agreement). The IRS and the Alliance expect to complete the development of this Agreement before the end of April 2005.

[77] *See* H.R. Conf. Rep. No. 105-599 at 235 (1998).

Free File opportunities (on irs.gov) can only be found within the Free File pages. Taxpayers can also seek free services through Volunteer Income Tax Assistance (VITA), Tax Counseling for the Elderly (TCE), Taxpayer Assistance Centers (TAC), Military, and Employee e-file sites.

Free File – The IRS should require the Free File Alliance to work with the states as a group and not on a case-by-case basis

At this time, the Free File Agreement (FFA) will continue to focus on the federal tax return only. Given the varying interests of the Free File members and lack of unity among states (many states have their own state-only Internet programs and have not agreed to give up their right to offer such programs in exchange for an agreement that would provide free commercial state services; other states without state-only programs are more agreeable to such arrangements), the IRS has determined not to expend the significant resources that would be required to pursue the development of a uniform approach at this time.

Free File – Notification of Charges for Preparation of State Tax Returns

The National Taxpayer Advocate asserts that many programs available under Free File do not inform the taxpayer of associated costs of filing a state tax return until the return is complete. We note, however, that all FFA members are currently required to disclose any costs associated with the preparation and filing of state returns on their Free File site on their "landing page," i.e., the first page to which a taxpayer is directed upon leaving the "IRS.gov" site. We continue to work with our Free File partners to ensure that the program is implemented according to agreements in place.

Free File – Develop a Method to Evaluate the Success of the Free File Program

The IRS favors the implementation and use of a Free File indicator (opposed by the Alliance) to measure the success of the program. The IRS continues to work with the Free File Alliance to implement a program measurement solution that is acceptable for both the IRS and the Free File Alliance. Currently, the IRS and the Alliance are considering the implementation of a Free File survey that will be available to (and will provide additional information about) Free File users only. Scope, development costs, schedule for survey implementation, etc., are key factors being considered for implementation during the 2005 filing season.

Free File – Taxpayer Privacy Concerns

The National Taxpayer Advocate believes that the IRS should not refer taxpayers to tax preparation programs which sell products to taxpayers because she believes that taxpayers will perceive the IRS as promoting cross-marketing and failing to ensure the privacy of their taxpayer information. The IRS disagrees. Internal Revenue Code § 7216 and the implementing regulations recognize the commercial nature of the tax return preparation industry and allows preparers to sell products to taxpayers as long as they obtain prior informed consent. The IRS should not unilaterally impose more restrictive standards on tax preparers. The IRS Restructuring and Reform Act of 1998 (RRA 98), §2001(a)(3) states that, "the Internal Revenue Service should cooperate with and encourage the private sector by encouraging competition to increase electronic filing of such returns." IRS should not adopt rules that interfere with the competitive process, especially when the rules would prevent taxpayers from making personal decisions about opportunities that may be of interest or benefit to them. We believe that Congress and the IRS have set the correct standard for taxpayer protection by insisting on informed consent, but recognizing that taxpayers should have the ability to make their own decisions and government should not interfere with their ability to do so. Free File members are Authorized IRS e-file Providers and therefore must adhere to all rules and regulations in place to safeguard taxpayer privacy and security.

Create a Template Method of Filing and Allow Direct Filing by Taxpayers of Commercially Prepared Returns

The IRS computers are not equipped to receive and process electronic transactions from individual taxpayers. To ensure the best processing possible, IRS relies on third party providers to batch electronic returns and send them in a format compatible with existing IRS computers. At present, this is the most efficient way to receive and process large volumes of electronic returns from individual taxpayers. The template method of filing would be a vastly inferior product to Free File's state-of-the-art preparation software and customer support. Creating a direct filing option for taxpayers that use commercial preparers would require development of a new infrastructure that would consume valuable resources in much the same way that supporting 2D bar code technology would. Developing multiple alternative processing schemes that might or might not appeal to small minorities of taxpayers is a less sound strategy than continuously improving our e-file offerings that are favored by the ever growing majority of taxpayers. Late adopters of e-file will ultimately be influenced by continued superior performance of e-file and the IRS' and the industry's dedicated determination to make e-file, safe and secure. A strong, reliable, safe and secure system is integral to supporting mandates.

Initiate Processing of 2D Bar Codes on Paper Returns as an Alternative to e-file

Two-dimensional (2D) bar coded returns are paper returns that require the same resources and overhead as other paper returns, even though there are some processing savings. RRA 98 in § 2001(a) states that the policy of Congress is that “paperless filing” is the 80 percent goal for IRS to be achieved through private sector competition. Some states allow both types of returns, but the IRS believes that offering taxpayers a paper alternative to e-file is counterproductive to Congressional e-file goals and sends taxpayers a mixed message as to what Service policy is with respect to e-file. While Congress may be changing its position on mandates, there is no indication that Congress has changed its policy on e-file. The new policy Congress seems to be formulating in H.R. 1528 is to mandate electronic filing, not revert to paper solutions.

TeleFile

Since Congress passed RRA 98, the IRS has expanded the filing options available to employers with the pilot of form 941 TeleFile. The IRS launched the program nationwide in 1998. In 2000, the online filing of Forms 941 was implemented. In 2001, TeleFile was expanded to include Form 4868. Despite these expanded options, TeleFile usage has dwindled in the last 4 years.

As part of RRA 98, Congress required the IRS to establish the Electronic Tax Administration Advisory Committee (ETAAC). ETAAC reported that TeleFile is the most expensive mode of processing returns (on a cost per return basis). Costs for the 1040EZ per transaction are as follows: TeleFile $2.63; Paper $1.51; and e-file $0.67. The TeleFile program is operating at a cost of $18.1 million per year, including system operating costs of 8.6M, and printing and postage costs of 9.5M. The ETAAC's recommendation to Congress is to eliminate TeleFile immediately and have the funds redirected to Modernized e-File (MeF). The Free File Alliance filing option is available to every TeleFile eligible taxpayer on the Internet at no cost thereby meeting Congressional expectations. Free File is superior to simply translating TeleFile to the Internet because taxpayers have access to state-of-the-art tax preparation software and customer support. Free File expands the base of taxpayers eligible for free e-file assistance that TeleFile would never be able to accommodate because of keystroke fatigue on Touch Tone phones. Russell Research shows if TeleFile was eliminated 37 percent would go back to paper with the remaining 62 percent willing to try another electronic method (mainly Free File). TeleFilers can use Free File from the public library. There are an estimated 116,618 public libraries in the US today. IRS walk-in sites will prepare returns and file returns electronically for taxpayers with an AGI of $35K or less. Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs also serve the entire TeleFile eligible population for individual returns.

TAXPAYER ADVOCATE SERVICE COMMENTS

We commend the IRS for its efforts to ensure the security of electronically transmitted tax return data. Specifically, the complete phase-out of support for non-encrypted transmissions should greatly improve the security of data and, if properly communicated, will allay taxpayers' concerns. Further, strict oversight of the industry by the IRS is essential to ensure that data is secure during the entire electronic preparation and filing process.

While it is clear that the IRS is currently prevented from imposing e-file mandates on preparers of individual income tax returns pursuant to IRC § 6011(e), the IRS should research the experience of the states with such mandates.[78] *The electronic filing environment for individual income tax returns has significantly changed since the mandate prohibition was added to the Code in 1982. Although the National Taxpayer Advocate does not presently have a position on this issue, the states' experi-*

[78] The research should cover the advantages and disadvantages as well as the support provided by the states which impose mandates on preparers (i.e., free e-filing, a template, etc.)

ence may be instructive.[79]

We are pleased that the IRS favors a Free File indicator to measure the success of the program. However, we are concerned that the proposed alternative to the indicator will be a voluntary survey, and thus result in the collection of incomplete data that does not represent the experience of all Free File users. Considering that Free File is a government sponsored program that receives indirect government endorsement, the IRS should be able to evaluate the basic effectiveness of the program as a basic condition of entering into the agreement in the first place.

The National Taxpayer Advocate continues to believe and recommend that the IRS should not refer taxpayers to a program that sells non-tax related products. Until the Treasury Regulations under IRC § 7216 are revised to address issues specific to electronic filing, we will continue to have taxpayer privacy concerns, especially with respect to the Free File program. We believe that the IRS has misconstrued the intent of the criminal penalty provision by interpreting the provision with reference to the language of the IRS Restructuring and Reform Act of 1998 (RRA 98) which encourages the IRS to cooperate with industry. Internal Revenue Code § 7216 was enacted to protect the confidentiality of tax return information given the commercial nature of tax return preparation.[80] *The statute limits the venues in which such information can be disclosed or used by tax return preparers and imposes criminal penalties on those preparers who violate the rules. The provision should in no way be read to directly encourage competition in the tax return preparation industry.*

As a matter of basic customer service, we think the government has an obligation to develop the infrastructure to allow taxpayers to e-file their tax returns with the government without being subject to two sets of fees. The IRS already receives more than 50 million individual returns electronically every year, so extending the capacity to allow direct transmission of returns should be feasible. If this infrastructure requires a long term solution, the IRS should start planning for it now. Congress encouraged the IRS to develop such a program in the RRA 98 conference report.[81] *Further, the IRS will run into a wall at some point among the category of taxpayers who do not want to pay to e-file due to cost, and the category of taxpayers who are mistrustful of sending their returns to any party other than the IRS. The IRS research suggested that these groups are significant in number – not just "small minorities." Indeed, it is the Free File Program itself that can be more accurately described as appealing to small minorities, because only about three percent of taxpayers used the service in 2004. In fact, fewer individuals filed through the Free File program in 2004 than through TeleFile, which the IRS has recommended to be discontinued due to low demand.*[82]

[79] Pub. L. No. 97-248, 96 Stat. 324 (1982).

[80] House Discussion on Conf. Rep., 92nd Cong., 117 Cong. Rec. 12118 (Dec. 9, 1971).

[81] Specifically, the conference report states "the conferees also intend that the IRS should continue to offer and improve its Telefile program and *make available a comparable program on the Internet*," H.R. Conf. Rep. No. 105-599, at 235 (1998). Telefile is a program akin to a basic template that allows taxpayers to file certain returns by telephone without charge. The IRS plans to eliminate Telefile in 2006.

[82] Of the approximate 128 million individual returns filed during the 2004 filing season, approximately 3.5 million were filed through Free File. Internal Revenue Service, 2004 Filing Season Statistics *(Aug. 27, 2004)*. Government Accountability Office, Tax Administration: IRS Has Improved Performance in the 2004 Filing Season, But Better Data on the Quality of Some Services Are Needed, GAO-05-67, 15 (Nov. 15, 2004). 3.7 million individual income tax returns were received through TeleFile in Filing Season 2004 as of August 27, 2004. See Internal Revenue Service "2004 Filing Season Statistics as of August 27, 2004," available at http://www.irs.gov.

The IRS has stated that it plans to discontinue TeleFile due to dwindling demand and the associated cost of the program. However, the number of individuals that filed through the TeleFile program in 2004 outnumbered those that filed through Free File. In addition, it is unclear if the agency effectively promoted the program to taxpayers. Further, the National Taxpayer Advocate is concerned that discontinuing TeleFile is contrary to the direction given by Congress in the RRA 98 conference report.[83] *Nonetheless, if the IRS goes forward with the decision to discontinue the program, it must devise a plan for those filers who revert to paper. Some current TeleFilers will not feel comfortable filing electronically through the Free File program for a variety of different reasons, such as security or privacy concerns or lack of internet access or computer literacy. Nor do all taxpayers qualify for free assistance from volunteer organizations or through the Taxpayer Assistance Centers, both of which are much less convenient to the taxpayer than merely picking up the phone to file.*[84]

While 2-D bar coded returns may not produce as many benefits as e-filed returns, the IRS must acknowledge that a certain population of taxpayers will always refuse to e-file for one reason or another.[85] *Even when the IRS meets the 80 percent goal, it will still need to make paper returns available to the 20 percent of taxpayers who continue to file in such manner. We disagree with the IRS's point that offering this technology to individual taxpayers would send mixed signals.*[86] *If taxpayers are properly informed about the benefits exclusive to e-file, it is doubtful that 2-D bar coding technology will attract current or prospective e-filers. However, such technology will still benefit those unpersuaded paper filers and the IRS by avoiding transcription errors and reducing processing costs.*

RECOMMENDATIONS

In addition to the initiatives described by the IRS, the National Taxpayer Advocate recommends that the IRS take the following actions:

- *Ensure that proper security measures are implemented during the entire e-file process. Once the IRS guarantees that electronically transmitted tax data is subject to stringent security measures, the agency should conduct an aggressive media campaign to inform taxpayers and preparers of these measures.*
- *Explore creating an electronic tax return template, which would enable all taxpayers to prepare and file their returns through the official IRS website. The template would represent the electronic equivalent of a paper tax form. Taxpayers or practitioners would enter tax data into the*

[83] *See* H.R. Conf. Rep. No. 105-599 at 235 (1998) ("[T]he conferees also intend that the IRS should continue to offer and improve its Telefile program and make available a comparable program on the internet."). At the very least, when taking actions such as this, the IRS should notify the public, including Congress, via a public notice and comment period.

[84] For a detailed discussion of issues related to these programs, see the Most Serious Problems on Taxpayer Access-Face-to-Face Interactions, *supra*, and Problems in the Volunteer Return Preparation Program, *infra*.

[85] See *IRS Strategic Plan 2005-2009*, 14 (IRS acknowledges that it must serve that part of the population that is computer-savvy).

[86] We note that the IRS trusts taxpayers to make decisions about non-tax related products marketed on the Free File program, but is concerned that taxpayers will be confused about choosing between e-file and 2-D bar coded paper returns.

template, which could perform simple computations and link the user to relevant IRS publications. Once all data is entered, the template would transmit the completed return directly to the IRS at no charge. Similarly, the IRS should explore creating a portal to receive the electronic transmission of tax returns prepared by commercial software without charge.

- *Encourage taxpayers to ask their preparers to e-file their tax returns. Similarly, the IRS should encourage preparers to educate their clients about the benefits of e-filing.*
- *Review the experience of several states that have imposed e-file requirements on certain preparers. What type of support is provided by the states to preparers subject to mandates? How effective are the mandates in increasing the rate of e-file? How are the mandates enforced and what types of exceptions are available?*
- *Consider implementing 2-D bar coding technology for individual income tax returns. This would afford some of the benefits of e-file to those taxpayers who refuse to e-file, and the IRS would benefit from reduced processing costs.*
- *If the IRS is determined to discontinue the TeleFile program, it must specifically advise Congress of this decision and detail its strategy to accommodate TeleFilers who will refuse to e-file. If the agency anticipates a certain percent will turn to services provided at VITA, TCE or TACs, it must sufficiently fund those programs to manage the overflow. In addition, the agency should further consider applying 2-D bar coding technology to individual income tax returns to accommodate those TeleFilers who return to paper filing.*

PROBLEM TOPIC B-8 — MOST SERIOUS PROBLEM: PROBLEMS IN THE VOLUNTEER RETURN PREPARATION PROGRAM

RESPONSIBLE OFFICIAL

Henry O. Lamar, Jr., Commissioner, Wage & Investment Division

DEFINITION OF PROBLEM

Since its inception in 1969, the Volunteer Income Tax Assistance (VITA) program has grown in the number of sites operated, volunteers serving, and returns prepared. Today, concerns are mounting over the quality of assistance VITA provides to taxpayers. The complexity of the tax law, specifically those provisions affecting lower income and elderly taxpayers, makes it necessary for the IRS to provide adequate training and resources to VITA volunteers. Further, because of the unique characteristics of the taxpayers VITA serves, an inaccurately prepared tax return can result in problems the taxpayers are ill-equipped to handle.[1]

The Treasury Inspector General for Tax Administration (TIGTA) has questioned the accuracy and quality of returns prepared at VITA sites.[2] This has raised larger questions about the VITA program as a whole, with a focus on whether the IRS can maintain VITA's growth and meet the needs of its partners, which are attempting to offer quality service to taxpayers.

ANALYSIS OF PROBLEM

The Fundamental Problem of the VITA Program

Last year, the Treasury Inspector General for Tax Administration (TIGTA) issued a well publicized report which concluded that the accuracy of tax returns prepared by the Volunteer Income Tax Assistance (VITA) program needs to be improved. Before a workable plan can be developed, however, the IRS must define more clearly its relationship to the organizations that operate VITA sites (often referred to as "partners")." This is currently a source of considerable confusion and frustration for the partners.

Although this discussion raises some difficult issues about the IRS and VITA, it is a discussion that must be held in order for the VITA Program to survive. Currently, the ambiguousness of VITA's relationship with the IRS is the underlying cause of many of VITA's problems. The IRS is consistently changing the level of support it provides to VITA sites and volunteers are constantly questioning how much will be required of them each year. This has led to growing criticism of the program and has many partners questioning their continued involvement in VITA. The IRS must first work with its partners to resolve this confusion regarding VITA before it can move forward and solve more specific problems related to resources, training, and the accuracy of the returns VITA prepares.

[1] The penalties and interest payments associated with an erroneous return can be costly, especially for low income and elderly taxpayers who are generally unable to handle these additional financial burdens. Michael A. O'Connor, *Quality Assurance and Best Practices for Community Tax Programs: A Report Prepares for the Annie E. Casey Foundation*, 1 (Dec. 2003).

[2] Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at Internal Revenue Service Volunteer Income Tax Assistance Sites*, Reference No. 2004-40-154 (Aug. 2004).

Background

History of VITA

Originating in the Tax Reform Act of 1969,[3] the Volunteer Income Tax Assistance Program was the result of an increased emphasis on taxpayer education.[4] VITA was designed to offer free tax preparation to individuals who are unable to afford professional assistance.[5] In 2000, responsibility for VITA shifted to the IRS' Stakeholder Partnerships, Education and Communication (SPEC)[6] organization, where the program has continued to grow.[7] For the 2004 filing season, VITA encompassed almost 240 coalitions with nearly 14,000 sites nationwide, which utilized the efforts of more than 100,000 volunteers to prepare and file more than 1.8 million tax returns.[8]

Diversity in VITA Sites

VITA is a diverse program comprised of several segments, including community-based VITA,[9] academic VITA,[10] military VITA,[11] Tax Counseling for the Elderly (TCE),[12] and co-located VITA,[13] each serving a different taxpayer population. This diversity allows VITA to

---

3 Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 730 (1969).

4 Stakeholder Partnerships, Education and Communication, *VITA Celebrates Its Thirtieth Year of Service*. Volunteer Income Tax Return Preparation has two components: the Volunteer Income Tax Assistance (VITA) program and the Tax Counseling for the Elderly (TCE) program. SPEC is responsible for the administration of both programs. TCE is funded separately from the VITA program through a grant from Congress. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2810, § 163 (Nov. 6, 1978). Throughout this discussion, any reference to VITA is to the community-based, academic, and military VITA programs. Whenever TCE is implicated, it will be specifically stated.

5 Stakeholder Partnerships, Education and Communication, *VITA Celebrates Its Thirtieth Year of Service*.

6 SPEC performs outreach and education for the Wage and Investment (W&I) division of the IRS. Its work focuses on three areas: tax awareness and education, tax preparation assistance, and financial literacy. Stakeholder Partnerships, Education and Communication, *SPEC Overview*, 1.

7 VITA sites have seen continued growth due, in part, to the reduction of return preparation services at many Taxpayer Assistance Centers (TACs). Taxpayers who would normally seek tax preparation assistance at these sites are now being directed to VITA sites for assistance. Field Assistance, *Talkpoints: Refocusing Our Resources; Fiscal Year 2003 Field Assistance Operating Procedures*, Appendix C; *Fiscal Year 2003 Individual Income Tax Return Preparation Procedures*, C-1-2.

8 It is important to note that these numbers may differ according to the source referenced. The numbers from the 2003 filing season had not been finalized and are subject to change. Stakeholder Partnerships, Education and Communication, *The SPEC Quality Initiative*, slide 2 (July, 2004). Today, working through community and military organizations, VITA volunteers prepare basic tax returns for low income taxpayers, English as a second language (ESL) or limited English proficiency (LEP) taxpayers, the elderly, and others with special needs.

9 Community-based VITA sites are run or sponsored by community groups including legal services organizations, churches, libraries, or other organizations aimed at providing services to low income and non-English speaking individuals.

10 Academic VITA sites are sponsored by an educational institution, generally colleges or universities, business or law schools.

11 Military VITA sites provide assistance with basic tax return preparation to members of the Armed Forces, their dependents, and in some locations to other employees at U.S. military establishments. IRM 22.30.1.2.15.1.1 Volunteer Tax Preparation programs (Oct. 1, 2003).

12 Tax Counseling for the Elderly (TCE) sites receive IRS grants to operate their tax assistance programs, which provide assistance to individuals who are age 60 and over.

13 Co-located VITA sites are those that are located in close proximity to Taxpayer Assistance Centers (TAC) and assist with the overflow of taxpayers needing tax return preparation assistance.

reach a greater number of taxpayers in need of free tax preparation. However, it can also create problems because different types of sites have different needs and structures, and creating procedures that meet these varied needs is difficult.

SPEC Organization

The mission of the Stakeholder Partnerships, Education and Communication organization is "to assist taxpayers in satisfying their tax responsibilities by building and maintaining partnerships with key stakeholders to inform, educate, and communicate with their shared customers."[14] One of the major functions of SPEC is the operation of the VITA and TCE programs. When VITA first transferred over to SPEC from Taxpayer Education, IRS employees actively recruited and trained volunteers, and established and ran local VITA sites.[15] Since the 2000 filing season, SPEC has changed its role in the program, embracing a coalition-based model in which responsibility for direct operation of sites has shifted to community partners. Under this new approach, SPEC still provides computers, software, training materials, and limited training opportunities. However, the bulk of the responsibility now falls to the sites themselves.[16]

Coalition-Based Model

The foundation of the current VITA program is the coalition-based model adopted by SPEC and designed to leverage scarce resources.[17] The base of this model is the development of "coalitions" – networks of local and national groups aimed at providing services to low income taxpayers.[18] These coalitions are then encouraged to set up numerous VITA sites across the country, using resources provided by coalition members to create self-sufficient sites.[19]

Despite SPEC's good intentions in allocating existing resources, there are concerns about the coalition-based model. A main concern of the National Taxpayer Advocate and many VITA partners is that responsibility for the program has shifted almost entirely away from the IRS and onto the shoulders of the sites themselves.[20] SPEC has acknowledged that the coalition

[14] Stakeholder Partnerships, Education and Communication, *SPEC Overview*, 1.

[15] Stakeholder Partnerships, Education and Communication, *SPEC Concept of Operations*, 2.

[16] Stakeholder Partnerships, Education and Communication, *Internal Revenue Service (IRS) Migrating the Legacy Volunteer Income Tax Assistance (VITA) Program to the Stakeholder Partnerships, Education and Communication (SPEC) Business Model: Redefining the Goals and Objectives of VITA Sites*, 3-5.

[17] Stakeholder Partnerships, Education and Communication, *Internal Revenue Service (IRS) Migrating the Legacy Volunteer Income Tax Assistance (SPEC VITA) Program to the Stakeholder Partnerships, Education and Communication (SPEC) Business Model: Redefining the Goals and Objectives of VITA Sites*, 4.

[18] In 2001, SPEC had 6 coalitions; in 2004 the number had grown to 238. Stakeholder Partnerships, Education and Communication, SPEC, slide 7.

[19] Self-sufficient VITA sites are able to obtain the required resources from their coalition sponsors and require little or no help from the IRS. Stakeholder Partnerships, Education and Communication, *Internal Revenue Service (IRS) Migrating the Legacy Volunteer Income Tax Assistance (VITA) Program to the Stakeholder Partnerships, Education and Communication (SPEC) Business Model: Redefining the Goals and Objectives of VITA Sites*, 4.

[20] These observations, and those set forth in the remainder of this article, are based on extensive discussions the National Taxpayer Advocate and staff have had with VITA partners and site organizers over the past two years.

model has "moved responsibility for many administrative activities associated with the volunteer tax preparation program to community partners."[21] This creates problems for many VITA sites, especially those not supported by large partner organizations. This move to self-sufficiency may help to economize scarce resources, but it may also shift too much responsibility to partners and leave the IRS with little responsibility or accountability for the outcomes.

VITA Resources

With the IRS's move toward self-sufficiency in VITA, the amount of resources dedicated to the program is critical. The actual budget dedicated to the VITA Program is difficult to calculate. However, the estimated costs for FY 2004 are more than $4 million; compared to the FY 2001 budget of less than $3 million.[22] While this increase is significant, when considering the numbers of sites operated and taxpayers assisted the current funding level is not enough to ensure adequate assistance is provided to all sites.

SPEC has developed a method of allocating its limited resources, dedicating them first to sites characterized as totally self-sufficient.[23] SPEC next allocates resources to combination partner and VITA sites, run by outside partners with support from the IRS. To determine which sites receive support, SPEC has developed a scoring system based on the following factors:[24]

1. Site Management	25 Points
2. Computers/Printers	20 Points
3. E-File Transmission Services	15 Points
4. Recruitment of Volunteers	10 Points
5. Training and Testing of Volunteers	10 Points
6. Supplies	10 Points
7. Recognition of Volunteers	5 Points
8. Space	5 Points
TOTAL	100 Points

[21] IRM 22.30.1.10.1.1(1) Community Based Partnerships - IRS Field Personnel (Oct. 1, 2003).

[22] Part of the difficulty in calculating the total amount of fund spent on the VITA Program comes from the fact that when the SPEC organization first stood up, they did not track their spending in the same way they do currently. This makes comparing prior years' spending difficult. It is important to note that when the VITA Program was under Taxpayer Education, the amount of support each VITA site received was at the sole discretion of the District Director and this resulted in vast differences in how sites were treated. The creation of SPEC has resulted in a more uniform method of allocating resources between sites. The total spending for FY 2004 is still an estimate; these numbers have not yet been finalized. These figures do not include labor and overhead for the SPEC organization. These figures also do not include the costs incurred by Modernization & Information Technology Services (MITS) for the purchase and maintenance of the software program used by VITA. Information provided by SPEC in response to an information request. (Nov. 23, 2004).

[23] Stakeholder Partnerships, Education and Communication, *Internal Revenue Service (IRS) Migrating the Legacy Volunteer Income Tax Assistance (VITA) Program to the Stakeholder Partnerships, Education and Communication (SPEC) Business Model: Redefining the Goals and Objectives of VITA Sites*, 4. Besides receiving priority in resources, these sites are also exempt from the VITA minimum operating requirements unless they receive tax preparation software from the IRS.

[24] *Id. See also*, IRM 22.30.1.4.3.4 (6) 1 Minimum Number of E-Filed Returns (Oct. 1, 2003).

Sites are awarded points based on the number and amount of resources they provide as opposed to being provided by the IRS. The higher the score, the more preference the site is given in the allocation of resources.[25]

VITA unquestionably suffers from a lack of funds. Given this reality, SPEC needs a fair and equitable method of determining how VITA resources are distributed among its sites. SPEC has acknowledged that it cannot treat start-up sites in the same manner as others, as these sites are greatly in need of SPEC resources and support. Currently, resources are directed first to the most self-sufficient sites, which require the least from SPEC, while sites that are more dependent on SPEC are given lower priority. This scoring system punishes smaller sites that cannot provide all of their own resources and are most likely to need IRS support. This approach creates a self-fulfilling cycle: small sites do not get the assistance and support they need to become self-sufficient, which will in turn make them eligible for more support.

Resource Issues

Computers

When the IRS began accepting electronically-filed returns in the mid-1980s, most VITA sites lacked the necessary equipment to take advantage of this innovation. In 1997, the IRS established the "Computers for Volunteers" program, and began offering surplus computer equipment to VITA for use in electronically filing returns.[26]

In August, 2002, however, a TIGTA audit raised concerns about computers sent to VITA sites.[27] The audit led to three main conclusions:

- The IRS could not physically account for computers provided to volunteers;
- The IRS did not ensure that taxpayer e-file data was removed from volunteer computers at the end of the 2001 filing season; and
- The IRS did not ensure that only authorized software was loaded on volunteer computers.[28]

[25] Resources are last applied to IRS "direct support" VITA sites, which are run by IRS employees who recruit and train the volunteers involved. According to SPEC, these sites only operate in areas where other organizations cannot be recruited, and their services are generally limited. Stakeholder Partnerships, Education and Communication, *Internal Revenue Service (IRS) Migrating the Legacy Volunteer Income Tax Assistance (VITA) Program to the Stakeholder Partnerships, Education and Communication (SPEC) Business Model: Redefining the Goals and Objectives of VITA Sites*, 4. SPEC also prefers VITA sites that file federal returns electronically and gives them priority over sites that prepare paper returns.

[26] Stakeholder Partnerships, Education and Communication, *Internal Revenue Service (IRS) Migrating the Legacy Volunteer Income Tax Assistance (VITA) Program to the Stakeholder Partnerships, Education and Communication (SPEC) Business Model: Redefining the Goals and Objectives of VITA Sites*, 1.

[27] Treasury Inspector General for Tax Administration, *Computers Used to Provide Free Tax Help and That Contain Taxpayer Information Cannot Be Accounted For*, Reference No. 2002-40-144, 3 (Aug. 2002). At the time, the IRS was providing over 6,600 desktop and laptop computers to VITA and TCE sites for e-filing.

[28] *Id.* at 3.

In August, 2003, partially in response to the audit, the IRS created a central computer depot to manage all the laptop computers in the program.[29] This approach allowed for stricter controls, including maintaining an inventory of the laptops, and providing customer service support to VITA sites while the computers were in use.[30]

Despite the enormous progress SPEC has made by developing the depot, problems still exist. In SPEC's 2003 Customer Satisfaction Survey, partners stated they were least satisfied with "Supplies and Computer Resources from SPEC," specifically the number of computers available for VITA use.[31] SPEC's goal is to maintain an inventory of 10,000 or fewer computers. While this number may seem significant, the VITA program had nearly 14,000 sites in 2004.

Computer Software

The IRS currently provides VITA sites with a commercially available, off-the shelf, form-based software program.[32] The IRS acquired this software in April 2000 under a Blanket Purchase Agreement. Through this agreement, SPEC also purchased a customer support help desk to assist VITA partners.

Despite these efforts, VITA sites are experiencing problems with the software. The 2003 Customer Satisfaction Survey reveals that partners feel the second biggest problem in VITA is computer training and technical support.[33] The 2004 survey is even more specific, with Training and Support for the SPEC-provided software being the second largest concern

[29] Stakeholder Partnerships, Education and Communication, *Why the Depot*, 1; Lyn Huntley, *La Dolce VITA; EUES Provides VITA Laptops for Filing Season* (May 24, 2004).

[30] Stakeholder Partnerships, Education and Communication, Why the Depot, 1-2, 8. The laptops will be inventoried, undergo the quality review process to have taxpayer information removed, and sorted before being prepared to be redistributed for the 2005 filing season. Lyn Huntley, *La Dolce VITA; EUES Provides VITA Laptops for Filing Season* (May 24, 2004).

[31] Internal Revenue Service Customer Satisfaction Survey, *Stakeholder Partnerships, Education and Communication (SPEC) Partners National Report*, slide 7 (May 2003). Out of a scale of 1-5, Supplies and Computer Resources from SPEC received a satisfaction rating of 3.59. Internal Revenue Service Customer Satisfaction Survey, *Stakeholder Partnerships, Education and Communication (SPEC) Partners National Report*, slide 11 (May 2003). In the feedback on the 2003 Customer Satisfaction Survey, partners noted that they needed more computer equipment to run their sites. The 2004 Customer Satisfaction does not appear to have asked this same question, so it is difficult to make any comparisons on how SPEC has responded to this concern.

[32] Stakeholder Partnerships, Education and Communication, *Electronic Filing*, p. 1 (copy of file with author). The IRS was required to use a commercially available software package due to an existing Memorandum of Understanding (MOU) between the IRS and the Free File Alliance, LLC, a consortium of companies in the electronic tax preparation and filing field. This MOU states "the IRS will not compete with the Consortium in providing free, online tax preparation and filing services to taxpayers." *Free On-Line Electronic Tax Filing Agreement*, 1 (Oct. 30, 2002).

[33] Internal Revenue Service Customer Satisfaction Survey, *Stakeholder Partnerships, Education and Communication (SPEC) Partners National Report*, slide 7 (May 2003). SPEC Computer Training and Technical Support received a satisfaction rating of 3.86 out of a maximum of 5. This is the second lowest satisfaction rating, following Supplies and Computer Resources from SPEC, which received a satisfaction rating of 3.59 out of a maximum of 5.

identified by partners.[34] Partners have commented that the software is burdensome, difficult to use, and should be replaced by more efficient software. Many partners said they encountered so many software problems in the 2004 filing season that site supervisors spent most of their time fixing problem returns instead of performing the quality reviews for which they are generally responsible.

The coming 2005 filing season marks the final year of the existing software agreement, and SPEC issued a request for proposals for new software in April 2003.[35] Recognizing the issues surrounding the current software, the request contains certain "enhancements," including interview-based software, additional training, and improved help features. While these features are crucial in responding to the needs of VITA, there is no guarantee that the request will bring VITA a replacement that meets these requirements. The process is based in large part on monetary costs, and the award will be made to the bidder whose proposal provides the best value to the government, with both price and technical aspects being considered.[36]

Training

The results of the 2004 Customer Satisfaction Survey indicate training is the most important resource that SPEC can provide its partners in VITA.[37] According to these partners, the biggest problems with training are that it is not offered frequently enough and does not meet the needs of VITA sites and volunteers.[38] When asked how SPEC could improve training, partners said it should be held further in advance of filing season, offered at more locations, and made more extensive. In response to this problem, SPEC is introducing online volunteer training for the 2005 filing season through a program entitled "Link and Learn Taxes," on the IRS website.[39] This will allow customized training for each volunteer and will help address the problem of insufficient classes being offered. By posting the various training modules online, SPEC will enable volunteers to complete the training at their convenience and obtain certification immediately. A CD version of the training will be available for sites with no Internet capabilities.[40]

[34] Internal Revenue Service Customer Satisfaction Survey, *Stakeholder Partnerships, Education and Communication (SPEC) Partners National Report*, slide 11 (June 2004), Training and Support for the current SPEC-provided software received a satisfaction rating of 4.08. Within this category, Frequency of Training received a satisfaction score of 3.81 out of 5and Training Support Provided to Your Organization received a score of 3.94 out of 5.

[35] Stakeholder Partnerships, Education and Communication, *Electronic Filing*, p. 2.

[36] Information provided by SPEC information request.

[37] Internal Revenue Service Customer Satisfaction Survey, *Stakeholder Partnerships, Education and Communication (SPEC) Partners National Report*, slide 11 (June 2004) Partners said that training was the resource that is most important to them, giving it an importance rating on 4.6 out of 5.

[38] *Id.* Partners gave frequency of training a satisfaction rating of 3.89 out of 5 and gave training meeting your organization's needs a satisfaction rating of 3.98 out of 5.

[39] Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at Internal Revenue Service Volunteer Income Tax Assistance Sites*, Reference No. 2004-40-154, 29-30 (Aug. 2004).

[40] Stakeholder Partnerships, Education and Communication, *SPEC's Volunteer Educational Products and Services*, 5.

While online training is likely to benefit the majority of VITA sites and volunteers, SPEC should still consider alternate methods. SPEC should consider partnering with outside groups that could assist with the training, especially those whose members run VITA sites across the country. These organizations include the American Institute of Certified Public Accountants (AICPA), the American Bar Association (ABA), and the Low Income Taxpayer Clinics (LITCs). The members of these organizations have extensive practical experience, which SPEC should make an effort to translate into valuable training for VITA volunteers. These groups can be asked to develop training materials, including videos and DVDs, on technical issues and interviewing techniques, which could be distributed to all VITA sites. It is understandable that SPEC cannot train all volunteers, but the sites must be given alternate methods of providing this instruction.

TIGTA Audit

In September 2004, the Treasury Inspector General for Tax Administration (TIGTA) reported the results of an audit of the VITA program conducted during the 2004 filing season.[41] TIGTA auditors visited 44 VITA sites and had 35 tax returns prepared. All 35 returns were completed incorrectly by volunteers. As a result, TIGTA raised concerns about how VITA handles returns, including the failure to use intake sheets or interview techniques, and to obtain sufficient information from the taxpayer to correctly apply the tax law.[42]

Audit Findings

The TIGTA audit results raise some serious questions about the quality of the work performed by VITA sites across the country. However, the National Taxpayer Advocate has reservations about the validity of the audit results, and questions whether they are representative of the quality of the actual work performed by VITA volunteers. TIGTA, in fact, acknowledges that the sample was not statistically valid.[43] Sites were selected "judgmentally" rather than randomly, and only 35 returns were included.[44] In addition, the auditors used only two taxpayer scenarios, which are not representative of work routinely performed at the VITA sites.

The audit report was quick to point out that the VITA sites prepared none of the 35 returns correctly.[45] While this statement may be correct, it is a misleading and unfair characterization of the audit results. A volunteer goes through many steps and makes a number of decisions in the course of preparing a return. He or she may handle 19 of 20 issues properly on a particular return, yet TIGTA would still say this was not a correctly prepared return.

[41] Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at Internal Revenue Service Volunteer Income Tax Assistance Sites*, Reference No. 2004-40-154 (Aug. 2004). It is important to note that the TIGTA audit focused solely on community-based VITA sites and did not involve a review of academic, military VITA or TCE sites.

[42] *Id.* at 5-12.

[43] *Id.* at 16, n.2.

[44] Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at Internal Revenue Service Volunteer Income Tax Assistance Sites*, Reference No. 2004-40-154, 5 (Aug. 2004).

[45] *Id.*

More fairly, it was not an *entirely* correct return. To say, in effect, that VITA volunteers were "zero for 35" is too simplistic and unfairly criticizes the program.

Further, by saying no returns were prepared correctly; TIGTA ignores the fact that the audit employed only two scenarios.[46] The first scenario dealt with a child who lived with the taxpayer for five and one half months of the taxable year; the second was that of a grandniece who lives with the taxpayer for eight months during the tax year. Neither represents the typical return completed by VITA volunteers. The first scenario was aimed at testing a volunteer's knowledge of the Earned Income Tax Credit (EITC), when according to VITA statistics from tax year 2004, only approximately 26 percent of returns completed by VITA involved EITC.[47] For the most part, taxpayers whose returns involve EITC tend to utilize paid preparers to obtain faster refunds.

The second TIGTA scenario focused on a grandniece, who could be treated as a foster child for purposes of the EITC and the dependency exemption.[48] This fact scenario is so rare and unique that the IRS-prepared training materials for volunteers did not even mention "grandniece" among the possible familial relationships for purposes of the EITC and the exemption.[49] Further, the software used by VITA provides numerous familial relationships for volunteers to choose from for EITC and dependency exemption purposes and grandniece/nephew is not one of these options.[50]

Most VITA returns are relatively simple and straightforward, usually involving determinations of eligibility for the dependency exemption under IRC § 151. Using the TIGTA scenarios, VITA volunteers calculated this exemption accurately 77 percent of the time.[51] The TIGTA report focused only on the overall accuracy of the returns, using scenarios that were completely unrepresentative of the work VITA performs. The audit appears designed to trip up volunteers on the minutiae of the law rather then test them on the common areas they deal with on a regular basis. The audit also focused solely on community-based VITA sites and offered no source for comparison.[52] A more comprehensive study would have tested the same scenarios with various types of paid preparers and IRS Taxpayer Assistance Centers (walk-in sites) to determine how VITA performed in comparison.

[46] Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at Internal Revenue Service Volunteer Income Tax Assistance Sites*, Reference No. 2004-40-154, 2 (Aug. 2004).

[47] Statistics provided by SPEC in response to an information request (Oct. 29, 2004).

[48] Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at Internal Revenue Service Volunteer Income Tax Assistance Sites*, Reference No. 2004-40-154, 27 (Aug. 2004).

[49] Internal Revenue Service, *Volunteer Assistor's Guide, Student Text*, Publication 678,1-4, 9-6 (2003).

[50] Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at Internal Revenue Service Volunteer Income Tax Assistance Sites*, Reference No. 2004-40-154, 27 (Aug. 2004).

[51] *Id.* at 7, Table 2.

[52] *Id.* at 16, n.1 (Aug. 2004). The audit did not compare VITA sites to other preparers such as enrolled and unenrolled preparers.

SPEC Response to Audit Findings

In response to the TIGTA findings, SPEC immediately created the Volunteer Tax Preparation Quality Improvement Team (Quality Team) charged with a mission of "creat[ing] a three-year Business Plan that integrates new and existing quality principles into the Volunteer Return Preparation program."[53]

While SPEC's effort to respond to TIGTA is commendable, there is concern that SPEC was unaware of many issues raised by the audit. The TIGTA report should not have been the first time SPEC heard about these major concerns.[54] The current coalition-based model used by SPEC may help to maximize resources, but may have also prevented SPEC from conducting a comprehensive quality review of the program. SPEC should consider using site assistance visits, similar to those conducted by the Low Income Taxpayer Clinic (LITC) program, to monitor VITA.[55] These visits would involve a detailed review of the operating procedures of a site, complete with a quality review of some returns. If any issues are identified, the site would be on notice and SPEC could work with the site to correct the problem. This is just one method SPEC can employ to ensure that VITA sites provide top quality service.

According to the IRS response to the TIGTA audit, SPEC plans site monitoring visits during which SPEC employees will observe volunteers preparing actual returns to determine if they are accurate. SPEC also intends to conduct what it calls "shopping" trips to various VITA sites in which employees will anonymously have volunteers prepare returns.[56]

The National Taxpayer Advocate has been advised that SPEC has asked both the American Bar Association Tax Section (ABA) and the American Institute of Certified Public Accountants (AICPA) to participate in these "undercover" visits. It is our understanding that the ABA has declined to participate. The National Taxpayer Advocate believes that such "sting operations" are a misuse of SPEC and its partners' scarce resources. These visits identify problems after-the-fact and in a punitive, confrontational manner. It is far more productive to apply SPEC and its partners' resources to up front training, program evaluation, and improvement initiatives. The National Taxpayer Advocate encourages SPEC and its partners to use their resources more positively and productively.

To ensure continued quality within the VITA Program, a method must be developed for

---

[53] Stakeholder Partnerships, Education and Communication, *The SPEC Quality Initiative*, slide 5 (July, 2004).

[54] In fact, the TIGTA audit was not the first time SPEC was made aware of accuracy problems within the VITA program. In Wage & Investment's Business Performance Reviews in June and July of 2002, SPEC noted low accuracy rates in returns prepared by both VITA and TCE sites; however this was attributed to the Rate Reduction Credit. *Wage & Investment Business Performance Review*, 45 (July 26, 2002); *Wage & Investment Business Performance Review*, 47 (June 21, 2002).

[55] The Low Income Taxpayer Clinic (LITC) Program is a grant program where qualified organizations receive matching federal grants to represent taxpayers in controversies before the IRS or provide tax outreach and education to English as a second language (ESL) taxpayers. Internal Revenue Service, *Low Income Taxpayer Clinics Grant Application Package Book*, Publication 3319, 1 (Rev. 05-2004).

[56] Treasury Inspector General for Tax Administration, *Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at Internal Revenue Service Volunteer Income Tax Assistance Sites*, Reference No. 2004-40-154, 31 (Aug. 2004).

someone besides VITA site managers to independently review the quality and accuracy of the returns being filed. SPEC should consider partnering with the AICPA, the ABA, the National Association of Enrolled Agents (NAEA), the National Association of Tax Professionals (NATP), etc. in an effort where CPAs and attorneys could "adopt" a VITA site. The tax professional could act as the tax expert at the site and assist in ensuring the accuracy of returns.

Besides noting the lack of a comprehensive quality review program, the TIGTA report also pointed out flaws in the software used by VITA. Changing from the current software to interview-based software will help to identify any issues the VITA volunteer might miss when he or she interviews the taxpayer face to face. The change will also assist volunteers in areas of the law with which they may be unfamiliar. By leading them through the questions that need to be asked, the software can help ensure that the volunteers reach the correct answers.

SPEC's efforts to improve the quality of VITA are well-intentioned. However, they raise the concern that SPEC is simply responding to an unfavorable TIGTA audit instead of taking the time to determine what would most help the program.

The Future of VITA

With all the concerns raised over VITA, from both within and outside the program, it is important to consider the future of volunteer tax return preparation. The foundation of this future is a discussion over who bears responsibility for VITA. Only when this decision is reached can the IRS and its partners move forward and establish a unified vision for the VITA Program.

The SPEC fiscal year 2005 program letter is designed to lay out the national objectives and goals for 2005 through 2007 for SPEC's programs, including VITA. In the letter, SPEC explains that it has "recalibrated [its] approach to defining partner self-sufficiency."[57] This new approach focuses less on SPEC's initial goal of minimal resource investment and more on determining the appropriate level of resources SPEC can and should provide to individual partners. The new goal, according to SPEC, is to have partners reach a level at which the partner "provides or contributes to the mutually desired business outcome at a cost that is acceptable to all parties."[58]

This approach appears to recognize that the current coalition-based model has a number of flaws. As noted previously, this stems in part from a lack of consensus over who has the ultimate responsibility for the VITA program. Despite this confusion over the basic principles of VITA, it is clear that the future of VITA and its viability as a national program is heavily reliant on the efforts of SPEC's partners.

[57] Memorandum from Marie A. Medeck, Director, Field Operations, to Area Directors, Stakeholder Partnerships, Education and Communication (SPEC) Field Operations, 8 (July 30, 2004).

[58] *Id.*, at 8-9.

Over the years, local and national partners have invested significant time, effort, and resources to the VITA program and the taxpayers it serves. Many partners, however, are experiencing a growing level of discontent, specifically with the support and guidance they receive from the IRS.[59] This is important because, as SPEC decides how best to divide its limited resources among sites, some may choose to end their affiliation with the program. Given the limited support partners receive from the IRS, for many there is little benefit to being part of VITA and many have considered ending their affiliation with VITA.

VITA offers an invaluable service to countless taxpayers who would otherwise have to pay to have their returns prepared. However, the time may have come to look at the program as a whole and determine what steps are needed to ensure its survival and continued growth. One of the most important considerations is the type of taxpayers VITA assists; lower income, disabled, military, and elderly taxpayers. Each of these groups has different needs, all of which VITA must remain prepared to serve. This involves crucial issues such as providing interpreters for non-English speaking taxpayers, extending hours for taxpayers who cannot visit sites during the day, and offering special accommodations to taxpayers who require them.

Besides the needs of taxpayers, the IRS must also remain aware of the needs of VITA sites. The sites are run by a variety of organizations, including legal aid organizations, academic institutions, community coalitions, and other independent groups. Each type of site has different needs that must be addressed to create high quality service. Some sites may need more actual resources from the IRS but less training and support; other sites may have the opposite needs, while still others sites may require full assistance and support.

The program's rate of growth is another issue of concern. Despite the great strides SPEC has made in expanding VITA, some groups of taxpayers across the country are still underserved.[60] While these taxpayers, particularly those in rural areas, are in need of VITA services, continued growth can also create a problem for the program. As noted earlier, as the number of VITA sites has risen, the program's funding has not experienced the same level of increase. This imposes a burden not only on the SPEC organization charged with running VITA, but on existing VITA sites that receive fewer resources and less support. In addition, the Taxpayer Assistance Centers (TACs) run by IRS employees are serving fewer taxpayers and directing the overflow to VITA sites, creating another responsibility for an already burdened program.[61] It is important to consider whether VITA can sustain this continued level of growth and how the IRS can support existing sites while helping to establish new ones.

[59] Internal Revenue Service Customer Satisfaction Survey, *Stakeholder Partnerships, Education and Communication (SPEC) Partners National Report*, slide 41, 44 (May 2003). Partners indicated they would be less willing to continue working with SPEC if SPEC provided less support.

[60] Memorandum from Marie A. Medeck, Director, Field Operations, to Area Directors, Stakeholder Partnerships, Education and Communications (SPEC) Field Operartions, 8 (July 30, 2004).

[61] Field Assistance, *Talkpoints: Refocusing Our Resources; Fiscal Year 2003 Field Assistance Operating Procedures*, Appendix C; *Fiscal Year 2003 Individual Income Tax Return Preparation Procedures*, C-1-2.

IRS COMMENTS

The IRS provides volunteer tax assistance programs to assist taxpayers in satisfying their tax responsibilities by building and maintaining partnerships with key stakeholders, seeking to create and share value by informing, educating and communicating with our shared customers. The IRS is dedicated to providing quality volunteer return preparation assistance and actively engages internal stakeholders and external partners in establishing roles, setting expectations and participating in program improvement efforts on a continuous basis since the FY 2001 IRS reorganization.

The IRS works with partners and coalitions which provide volunteer return preparation services[62] for Wage and Investment (W&I) taxpayers. Particular emphasis is placed on the underserved segments of the W&I low-income taxpayer population, which includes elderly, Limited English Proficient (LEP) and disabled taxpayers. The IRS has established partnerships with more than 60 national organizations representing financial institutions, educational institutions, tribal governments, community and volunteer organizations and many others. At the local level, the IRS has formed over 265 coalitions, up from 6 coalitions in FY 2001, representing thousands of partners. Many of these coalitions are also underpinned by local affiliates of national partners. These partners choose to participate and invest in SPEC's business model[63] because it meets their specific organizational objectives of building assets for underserved populations.

The IRS provides partners with tax law and software training, marketing materials, educational products, research data for optimal site placement and effectiveness, supplies, technology support (software, computers and printers) and the necessary products, procedures and technical expertise for effective site operations. Partners provide direct funding and in-kind contributions such as leadership, volunteers, marketing support, volunteer training and equipment to the business model equation.

We believe the IRS business results and empirical data indicates that the business model and resource support commitment is effective in meeting growing partner and customer needs.

The criteria stated in the TAS report for the IRS to determine resource allocation to partners is inaccurate. The IRS uses a finite set of resources in concert with a leveraged business model to execute the VRPP. The foundation of our business model rests on two guiding assumptions. The first is that taxpayer needs will always exceed IRS resource capacity. The second is that sustaining quality taxpayer services is enhanced when communities take shared ownership in the delivery of services. The business model is geared towards involving partners who have a shared interest in service to taxpayers and can assist in reaching the

[62] The Volunteer Return Preparation Program (VRPP) currently supports some 70,000 volunteers and nearly 14,000 volunteer tax preparation sites. The VRPP is comprised of VITA, including military VITA, and Tax Counseling for the Elderly (TCE).

[63] SPEC's business model includes three components – volunteer return preparation, outreach/education and asset building. The use of partners or intermediaries is the cornerstone of SPEC's business model, a term which is sometimes interchanged with "leveraged business model."

maximum number of taxpayers for the resources invested. Guidance and flexibility are provided to front-line employees to consider taxpayer coverage, return and e-file productivity and partner contribution. Since introducing the business model in FY 2001, the IRS and partners have worked together to address roles, expectations and program improvements. These issues have evolved and continue to change with experience, partner involvement and partner feedback.

The TAS Report states further that the business model predominately supports large sites and, therefore, places small sites at a disadvantage. The 2004 Partner Satisfaction Survey conducted by an independent organization, the Pacific Consulting Group (PCG), profiled a statistically random sample of partners. The results profile a program that is dominated by a large number of small volunteer sites. Of more than 1320 respondents:

TABLE 1.8.1, VITA PROGRAM PROFILE

# of Taxpayers Served	# of Volunteers/Staff	# of Sites Operated
32% serve 1-100 taxpayers	53% have 1-10 volunteers or staff	58% operate one site
45% serve 101-1,000	34% have 11-15 volunteers of staff	23% operate 2-5 sites
23% serve over 1,000	13% have 16 or more volunteers or staff	19% operate over 5 sites

Primary measures of success are currently gauged by volume of returns, percent of returns e-filed, math accuracy percentage, partner survey satisfaction and customer (taxpayer) survey satisfaction results. Additionally, the IRS measures taxpayer access to volunteer return preparation sites using demographics (i.e., EITC and income) to ensure appropriate coverage of the underserved population segments.

Employing the business model enabled the IRS to increase volunteer return preparation and the e-file rate from 1.1 million returns and 61 percent e-file in FY 2001 to 1.9 million returns and 71 percent e-file in FY 2004. The VITA/TCE math accuracy rate for 2003 returns was 97 percent in comparison to a 95 percent math accuracy rate for all W&I returns. By increasing the percent of volunteer returns prepared by partners versus IRS employees from 65 percent in FY 2002 to 98 percent in FY 2004 and engaging partners in providing e-file services, IRS provided service to more taxpayers and provided fast, secure return preparation that exceeds the six percent increase in IRS staff investment during the same period.

Feedback from our Partner Satisfaction Survey conducted by PCG shows scores that bear out the high level of overall satisfaction with IRS support. The statistically valid national score for overall satisfaction at the national level reflects 4.25 on a five-point scale. Feedback from FY 2003 Customer Satisfaction Survey for non-AARP customers (conducted every other year) reflects a 96 percent overall national customer satisfaction rate. AARP conducts a separate Customer Satisfaction Survey and for FY 2004 95 percent were very satisfied with the AARP Tax-Aide program and 93 percent were very likely to recommend AARP Tax-Aide program to others.

Additionally, the IRS provides research including demographic data and expertise to assist partners in effectively accessing and serving their customer base. A 2004 analysis of sites and census data showed that 98 percent of low-income taxpayers are within 45 minutes of a volunteer return preparation site and 84 percent of the sites were within 5 miles of low-income taxpayers. For FY 2004 the average income of electronically filed volunteer returns was approximately $22,000 with 24 percent claiming EITC and 19 percent claiming Child Tax Credit (CTC). Accomplishments of this magnitude with IRS' finite set of resources is due to the business model IRS employs while providing partners with quality tools and services to reach vast numbers of taxpayers.

The TAS report indicates that the IRS has withdrawn support from partners while shifting responsibility to partners. In absolute terms, the IRS has devoted more staff hours, technical resources, training and support products to volunteer tax programs each year since FY 2001. The percent of staff hours to direct hours devoted to return preparation (including training hours) increased from 18.7 percent during 2001-2002 to 21.6 percent in 2003-2004. The IRS does agree with the TAS report that with partner and customer growth, the relative support given to any one partner has declined. The IRS has focused on the business model and annual improvements to services and products, while working with partners to identify and employ efficiencies of operation.

In technology support, the IRS increased its budget from $2.9 million in 2001 to $3.3 million in 2004. This does not include nearly $3.5 million in VITA funds that have been used over this period to purchase computers, printers and printer/computer peripherals. During this same period, the IRS increased its purchase of software packages from 5,862 packages in 2001 to 7,294 packages in 2004. During FY2004, IRS provided 10,000 computers and 5,800 printers.

The TAS report indicates technology is deficient – too few computers and software that is difficult to use. The IRS recognized this and has steadily addressed both these issues by:

- Establishing Computer Depot to provide higher quality computers and consistent software;
- Providing additional help lines to support partners' technology needs around computer operation;
- Continuing help line for volunteers using IRS provided tax preparation software; and
- Adding a technology help line for select partners to resolve hardware compatibility issues.

In addition, a number of partners bring equipment to their operations and utilize resources in their community. Data from an informal sample of partners showed they provided two computers to each computer provided by the IRS. This provides greater flexibility for partners and also ensures the necessary computer support for their program.

Training materials have also increased and evolved over the years. Partners have joined the IRS in developing training and reference materials that are tailored to partner/volunteer needs. Examples include:

- Understanding Taxes Online - for students or beginning volunteers
- Link and Learn Taxes Online - for new and returning volunteers
- Integrated (tax law and e-file instruction) VITA called Condensed-VITA or C-VITA - for volunteers with experience in tax law and computer skills
- Traditional VITA/TCE - modularized in three sections-- Basic, Wage Earner and Pension Earner
- Foreign Student and Scholar VITA/TCE – for volunteers assisting foreign students at universities
- Military VITA

Available IRS resource and reference guides to be used at volunteer sites to reinforce training include:

- Publication 4012, Volunteer Resource Guide
- Publication 3189, Volunteer e-file Administrator Guide
- Publication 1084, Volunteer Coordinators Handbook
- Publication 4011, Volunteer Resource Guide for Foreign Students and Scholars

The TAS report states that communications between the IRS and partners are broken and that partners do not understand what is expected of them. The IRS relationship managers throughout the country work with each of their national and local partners to proactively communicate, listen, support and provide guidance when needed. The Partner Satisfaction Survey findings show clearly that the highest score for IRS is in relationship management as we received an average score of 4.43 on a 5-point scale from local partners and a 4.65 from national partners. Relationship management includes such components as Communicating Timely, Sharing and Updating Information and Listening and Responding to Partner Concerns/Questions, all of which scored 4.39 or higher.

To facilitate open communication throughout the year and provide forums for exchange, the IRS participates in numerous meetings and conferences with national and local partners. The IRS establishes Memoranda of Understanding with many national partners to clearly outline the roles and expectations of both the partner and the IRS. In further support of partner communications, the IRS developed a partner and volunteer web page which provides direct access to IRS outreach materials and products to assist partners in their outreach and education campaigns. The site also features quality alerts and other key procedural information for partners and volunteers. The IRS devotes a significant number of staff hours at the local and national levels to creating and sustaining partner relationships and effectively communicating with all partners and would welcome other opportunities or forums for exchange.

ADDITIONAL INITIATIVES TO IMPROVE PRODUCTS AND SERVICES

Quality Initiative

The TAS report cites TIGTA findings on the accuracy of volunteer returns prepared during 2004. The IRS agrees that the scenarios were not reflective of the customer base at the volunteer sites and the sample size used by TIGTA when they performed their review was not statistically valid. The IRS recognized the need to expand the definition of accuracy beyond math error during FY 2003 discussions with partners. As a result of those discussions, as well as the TIGTA findings, the IRS and its partners are implementing a multi-year quality assurance program that will support and measure the tax law accuracy of return preparation. Plans include:

- Updating training products and strengthening volunteer certification procedures to ensure volunteers are qualified to prepare tax returns.
- Implementing a 3-tiered quality assurance program. The IRS will perform site observation reviews at a statistically valid sample of sites. During the reviews, IRS employees will observe volunteers preparing actual returns to determine if returns are prepared accurately. To supplement the site observation reviews, the IRS is pursuing partner involvement to perform a limited number of shopping visits using taxpayer scenarios indicative of volunteer return filing characteristics. The Advocate characterizes these shopping visits as "undercover activities" and "sting operations." To the contrary, we have discussed this with our partners and they agree to and support these visits as one initiative in our overall strategy to improve quality. Last, the IRS will perform a statistically valid number of site reviews to assess adherence to the IRS guidelines such as volunteer certification and site operation requirements. Results of all reviews will be shared with IRS employees and partners throughout the filing season for corrective action.
- Enhancing the IRS database for site information and strengthening validation procedures to increase the accuracy of site information for customer inquiries.

Rural Strategy Pilot

The IRS and Partners have worked to serve rural taxpayers since 2001. Of note are initial efforts to work with Tribal Governments and targeted rural areas in concert with external partners. In an effort to broaden and more fully measure rural efforts, a more formal rural strategy was developed in FY2004. Demonstration projects have been implemented in collaboration with IRS Partners to support EITC/CTC outreach and return preparation to a number of rural areas nationwide for FY2005. The results of the demonstration projects will be used to expand rural services in future years.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate continues to strongly support the VITA Program, and champion the tireless efforts of its volunteers in assisting an underserved segment of taxpayers. No one is questioning the invaluable work VITA performs. The National Taxpayer Advocate is concerned, however, that the ambiguity surrounding the current program design is a strategic problem that must be solved. Otherwise it causes problems such as in the site observation reviews where the IRS observes actual taxpayer return preparation and thereby compromises taxpayer privacy (see discussion below). Also, and equally important, it leads to one set of standards for VITA volunteers and a lesser set of standards for paid preparers.

The IRS is to be commended on its rural strategy pilot. The National Taxpayer Advocate is well aware that taxpayers in rural areas are often underserved by return preparation services. The National Taxpayer Advocate continues to support the IRS' efforts to expand the VITA Program to Native American and rural communities that are currently underserved.

The National Taxpayer Advocate is very pleased by the IRS' efforts in providing demographic data to its partners to allow them to effectively reach and serve their customer base. The IRS must engage in research specific to its target population to make sure that the IRS is successful in meeting taxpayer needs. This data should also prove useful as the IRS looks to increase the number of VITA sites in rural communities.

The IRS is to be commended on the results from the FY 2003 Customer Satisfaction Survey. The National Taxpayer Advocate does not dispute the satisfaction that taxpayers have with the services they receive at VITA sites; however, there are some concerns with other aspects of the program. The IRS is also to be commended for the development of the new online training program for VITA volunteers. The training provided to volunteers is essential, and the new online option is an important part of the IRS's effort to increase training materials and resources for the VITA Program. As the IRS continues to improve the types of training provided, the National Taxpayer Advocate recommends that the IRS partner with outside groups that can assist the IRS in providing this training.[64]

[64] These groups could include the American Bar Association (ABA), the American Institute of Certified Public Accountants (AICPA), the National Association of Enrolled Agents (NAEA), the National Association for Tax Professional (NATP), Low Income Taxpayer Clinics (LITCs), local business and accounting schools, and community college accounting programs.

While the training provided to VITA sites is critical, many sites rely on the IRS for computer support as well. The National Taxpayer Advocate is pleased with the efforts the IRS has made in developing the computer depot and working to ensure that the laptops provided to VITA sites are functional and up-to-date.[65] *We are pleased by the addition of help lines for VITA sites to assist in resolving computer and software issues.*

The software used by the VITA Program is one of the most important resources provided by the IRS. The National Taxpayer Advocate is concerned that the current software is not meeting the needs of the program. The VITA Program needs interview-based software that will help volunteers ask the right questions and arrive at the right answers. During the current open bid process, the National Taxpayer Advocate recommends that the IRS contract for an interview-based software program that will meet the needs of the VITA Program.

The National Taxpayer Advocate acknowledges that the IRS' efforts within the VITA Program are hampered by severely limited resources. Despite limitations, the IRS should reevaluate its current business model. The National Taxpayer Advocate disagrees with the IRS on the effectiveness of the current model and its ability to meet growing partner and customer needs. In its response, the IRS has not denied that it allocates resources according to the method we cited; in fact this method is set forth in the Internal Revenue Manual. Moreover, the IRS fails to explain how its two assumptions guide resource allocation.

While the IRS data shows that the majority of VITA sites are small to medium-sized, one of the current primary measures of success is the volume of returns prepared by a site and the percentage of returns e-filed. This indicates that resource allocation is being guided, at least in part, by certain "success" measures. The National Taxpayer Advocate is concerned that this will result in more resources being dedicated to larger sites that are already more self-sufficient and have a greater ability to e-file returns. This could leave smaller sites, which serve important groups of taxpayers, without adequate resources from the IRS. The National Taxpayer Advocate recommends that the IRS develop a fair and equitable method of distributing resources to VITA sites. The issue of limited resources also raises the need for additional Congressional funding for return preparation services for low-income taxpayers.[66]

The IRS and the National Taxpayer Advocate are in agreement that the scenarios used during the recent TIGTA audit were not reflective of the work the VITA Program performs. We are pleased that the IRS is engaging in a quality assurance review of the VITA Program; however, the IRS should reexamine the methods it is planning to use. We applaud site reviews, site assistance visits, and the development of standard operating procedures in an effort to maintain quality at VITA sites.

[65] It is important to remember that these computers sometimes cause technological problems for the VITA sites as well.

[66] *See S.* 882, Tax Administration Good Government Act, 108th Cong. § 7526A (2004).

Nevertheless, the National Taxpayer Advocate is extremely concerned by the proposed use of site observation and "shopping" visits at VITA sites. These site observation visits are a violation of taxpayer privacy and unfairly target low income taxpayers. Currently, the IRS does not send employees into the offices of paid preparers to observe them preparing tax returns, nor should they do this for the VITA Program. These IRS employees will be able to view sensitive taxpayer information and listen in on conversations taxpayers are having with their return preparers. The IRS should not be turning a volunteer-run program into the IRS by having volunteers' every action monitored by IRS employees. Additionally, the IRS should not be reducing taxpayer privacy as a price for taxpayers to obtain free return preparation services. Any attempt to do so will be met with strong resistance from the National Taxpayer Advocate.

The undercover shopping visits are also not a method the IRS should use to ensure accuracy in the VITA Program, and are not a productive use of SPEC's already limited resources. The National Taxpayer Advocate strongly encourages the IRS to eliminate any plans to use these undercover audits and instead use resources more effectively. While the IRS states that it has discussed this with partners and they support these visits, the National Taxpayer Advocate has spoken with a number of partners who are strongly against them. If the IRS is concerned about the quality of service in the VITA Program, it should partner with outside groups and encourage CPAs and attorneys to adopt VITA sites and provide tax expertise to the volunteers at those sites.

The fundamental issue for the future of VITA is the ambiguity surrounding the management of the program. While the IRS is constantly engaging with it partners on all aspects of the VITA Program, questions still remain. Despite claims by the IRS, nowhere in this report does the National Taxpayer Advocate claim that communication between the IRS and its partners is "broken." We cite the ambiguity and confusion surrounding the VITA Program as the source for many of its problems. We also note that there is a growing level of discontent among partners; we believe that this, too, is due in part to the current ambiguity surrounding VITA. The IRS is to be commended for its efforts to facilitate open communication with its partners, including the development of a partner and volunteer webpage. This, however, does not solve all of VITA's problems.

The IRS must engage in an open discussion with all parties involved and determine the role it wishes to play in the VITA Program, including the level of oversight it is willing to provide. If it is agreed that partners and individual VITA sites are ultimately responsible for themselves, the IRS must acknowledge this and step back. If VITA is essentially independent from the IRS, then the IRS should not be entitled to set standards for VITA, nor should the Federal government be auditing the program and the accuracy of the services it provides. Additionally, it is important to note that the IRS does not perform these same types of audits for paid preparers.

If, however, the IRS wants to retain responsibility for VITA and set the standards that sites must meet, it must be willing to give the sites more than it currently provides. The IRS must be willing to change its relationship with VITA from one that is merely supplementary, where the VITA sites are providing a service the IRS is unwilling to provide, to a relationship that is complementary, where the IRS and VITA sites work together to provide a service and achieve a specific goal. Additionally, the IRS must be willing to take responsibility for the program, taking not only the positive benefits that come from assisting taxpayers, but also the negative publicity when problems arise.

The IRS must also provide adequate funding for the program. From 1999 to 2004, the number of VITA sites grew from 6,000 to nearly 14,000,[67] *an increase of 8,000 sites. From 2001 to 2004, the amount of technology support provided to the VITA Program increased from $2.9 to $3.3 million,*[68] *an increase of $400,000. Thus, technology support decreased from $483.00 per site to $236.00 per site on average, a decrease of more than 50 percent. The funding and support provided by the IRS have not been increasing at a rate sufficient to keep up with the growth of the program.*[69] *The IRS needs to engage in strategic thinking regarding the future of the VITA programs and the support it is providing. It needs to determine the growth limit of the program and how to respond when that limit is reached. The IRS must also determine what additional types of support older VITA sites are going to need and who will be providing that support.*

As the IRS considers the future of VITA, it must take a hard look at the needs and concerns of local and national partners, without whose continued support the program will cease to exist. SPEC must engage in open and honest communication with partners to better understand their needs. Even if these needs cannot be met, the IRS must understand what is missing in order to best advocate for and protect the program.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

- *Engage in an open discussion over who bears the ultimate responsibility for the VITA Program and clarify its relationship with the volunteer organizations that operate VITA sites.*
- *Engage in strategic thinking regarding the future of the VITA Program and the support it is providing.*
- *Reevaluate its current business model and develop a fair and equitable method of determining how resources are distributed among VITA sites.*

[67] Stakeholder Partnerships, Education and Communication, *VITA Celebrates Its Thirtieth Year of Service*; additional information provided by IRS response.

[68] Information provided by IRS response. It is important to note that budget information is not available prior to 2001 when the VITA Program was under Taxpayer Education.

[69] Similarly, while the IRS stated that the percent of staff hours devoted to return preparation, including training, have increased, there is no indication as to whether this increase has been in proportion to the growth within the VITA Program.

- *Contract for an interview-based software program that meets the needs of the VITA Program.*
- *Partner with outside groups that can assist the IRS in providing training to VITA volunteers.*
- *Eliminate any plans to use IRS employees or outside groups to conduct undercover "shopping visits" to VITA sites.*
- *Partner with outside groups and encourage CPAs and attorneys to adopt VITA sites and provide tax expertise to the volunteers at that site.*
- *Develop a program where experienced VITA sites will mentor new VITA sites.*

PROBLEM

TOPIC C-9 MOST SERIOUS PROBLEM: INCONSISTENT CAMPUS PROCEDURES

RESPONSIBLE OFFICIALS

Mark E. Matthews, Deputy Commissioner, Services and Enforcement
Henry O. Lamar, Jr., Commissioner, Wage and Investment Division
Kevin M. Brown, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) reconfigured the IRS from an organization with a National Office, Regional Offices, and District Offices into a structure of business units and campuses.[1] The rationale for this reorganization was, in part, that the previous configuration did not promote continuity and accountability.[2] As an additional effort to provide consistency to taxpayers, the IRS has instituted nationwide procedures for campuses (formerly known as service centers). This uniformity is designed to enhance the transparency of the IRS' dealings with the taxpayer so that a taxpayer's account in one locale is treated the same way and achieves the same result as that of a similarly situated taxpayer in a different location.

Notwithstanding the attempt to create transparency and uniformity, inconsistent policies and procedures related to the handling of taxpayer accounts still pervade the campuses. These different and inconsistent procedures include addressing the tax consequences of stolen identities, Automated Collection System (ACS) levy release procedures, audit reconsiderations, and correction of collection statute expiration dates.[3] Inconsistent campus procedures inevitably result in disparate treatment for similarly situated taxpayers, and in many instances result in IRS actions that are contrary to the law and sound public policy.

ANALYSIS OF PROBLEM

Background

As required by RRA 98, the IRS began reorganizing in 1999. Its previous geographic structure with four regional offices, 33 district offices and 10 service centers, was eliminated. The new IRS consisted of a National Headquarters and eleven IRS business units, comprised of:

Four operating divisions:

- Large and Mid-Size Business (LMSB);
- Small Business/Self-Employed (SB/SE);

[1] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, Title 1, Subtitle A, § 1001(a)(2) and (3), 112 Stat 685.

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

[3] *See* Collection Statute Expiration Date, *infra* for discussion of inconsistent procedures related to collection statute expiration dates.

- Tax Exempt and Government Entities (TE/GE); and
- Wage and Investment (W&I).

Two support divisions:

- Agency-Wide Shared Services (AWSS); and
- Modernization, Information Technology and Security (MITS) Services.

Five functional business units:

- Appeals (AP);
- Chief Counsel (CC);
- Criminal Investigation (CI);
- Communications and Liaison (C&L); and
- Taxpayer Advocate Service (TAS).

The 10 service centers, which the IRS renamed "campuses," retain responsibility for Submission Processing, Accounts Management, and Compliance, although an individual campus may not serve all three functions. Instead of one director overseeing each campus, there is now a director for each function that exists at a given site.

Problem

Each operating division is required to review and update procedures and issue employee alerts to guarantee consistency of administration across the nation. In practice, however, the campuses often develop their own local procedures. Depending on which campus the taxpayer or tax practitioner is working with, a different result may occur. The result, on occasion, may be contrary to law or public policy. A sample of the areas where inconsistent procedures persist is set forth below.[4]

(1) Stolen Identities

Identity theft occurs when someone uses the personal information of another, such as a Social Security number (SSN) or credit card number, for unlawful purposes.[5] Identity theft is increasingly common throughout the United States,[6] with 500,000 to 700,000 people becoming victims of identity theft every year.[7] The victims of identity theft must often go through a seemingly endless bureaucratic maze to restore their identities on the databases of creditors, credit reporting agencies, and Federal, state, and local governments.

---

[4] For a discussion on inconsistent campus procedures related to collection statute expiration dates, *see* this report, Most Serious Problem, Collection Statute Expiration Dates, *infra.*

[5] *Identity Theft: The Nation's Fastest Growing Crime Wave Hits Seniors, Hearing Before the Senate Special Committee on Aging*, 107th Cong. (2002) (opening statement of Chairman John Breaux), at http://aging.senate.gov/events/hr87jb.htm (hearing publication unavailable as of Oct. 2002).

[6] *Id.*

[7] *Id.* (Statement of Alice S. Fisher).

Theft of property is not the only motive for this crime. For example, the only way persons without SSNs can obtain work from a law abiding employer is to use a false SSN.[8] Thousands of SSNs are stolen for this purpose annually. While employment is perhaps a more innocuous motivation than property theft, the bureaucratic morass facing victims is often no less severe.

Dealing with the IRS is part of this morass. When an individual uses another's SSN to obtain work, the employer will (or should) file a Form W-2 for that individual with the Social Security Administration (SSA) at the end of the year.[9] When the IRS accumulates all the wage information earned under the SSN for the year, it will reflect the wages earned by the rightful owner of that number as well as those of the individual who wrongfully procured the SSN.[10] The rightful owner will, of course, only report the wages he or she earned, and is likely to become locked in a dispute with the IRS over the contested wages until the rightful owner of the SSN can persuade the IRS that he or she is in fact the rightful owner.

The Internal Revenue Manual (IRM) contains procedures for situations where different taxpayers utilize the same SSN.[11] These procedures involve: (1) researching IRS databases for information which might establish the correct SSN owner, (2) sending a letter to each taxpayer using the SSN (Letter 239C) along with a questionnaire seeking documentary evidence supporting the use of the SSN, and (3) suspending activity on the account for 40 days.[12] Surprisingly, the IRM does not require IRS personnel to attempt to contact the taxpayer by phone. The application of these procedures will produce one of two results, which in IRS parlance are known as "mixed entity,"[13] and "scrambled SSN."[14]

In a **mixed entity** case, the IRS determines which taxpayer is entitled to use the SSN and will abate any tax, interest, and penalties which were assessed to the rightful owner of the SSN but were attributable to wrongful use of the number. The correct owner will be permitted to continue using the SSN, while the other taxpayer will be issued a temporary tax identification number (TIN).

The problem occurs when the IRS cannot or does not determine the correct owner of the SSN. In such a case, the IRS uses its **scrambled SSN** procedures to assign a temporary number to each taxpayer and prohibits either taxpayer from using the disputed one. These procedures compound problems for the rightful owner of the SSN, whose identity

[8] IRC § 6109(a)(2).

[9] Treas. Reg. § 31.6071(a)-1(a)(3).

[10] The IRS runs an Automated Underreporter program that compares the Forms W-2 and other information returns under a particular SSN with the income reflected on an individual's income tax return.

[11] IRM 21.6.2.4.2, Scrambled SSN Procedures, and IRM 21.6.2.4.3, Mixed Entity Procedures.

[12] IRM 21.6.2.4.2.2.

[13] RM 21.6.2.4.3.1(1).

[14] IRM 21.6.2.4.2(1).

with other creditors and credit agencies has been compromised. The decision to scramble the numbers of all taxpayers using the SSN also creates hardship, because once scrambled, a case can take years to resolve while the SSA investigates and determines which taxpayer may rightfully use the number.[15]

Taxpayers often come to TAS when they discover that others are wrongfully using their SSNs. TAS case advocates have encountered difficulty working these cases because of differing procedures at different campuses. Some examples of inconsistent procedures follow.

- Some campuses assign a temporary number to the taxpayer who has not provided proof of the right to use the SSN and allow the "correct" taxpayer to continue using the SSN. However, other campuses make a practice of assigning temporary numbers to both taxpayers, even though one of them has been determined to be entitled to the number.
- Some campuses require taxpayers claiming stolen identity to provide a police report to prove the theft has been reported to law enforcement officials, while other campuses have no such rule. The need for a taxpayer to produce a police report is neither required by the IRM nor is it practical. For example, a TAS analyst whose identity was stolen in December 2003 waited several months for the police to take his report, despite numerous calls; obviously, he would have been unable to fulfill this requirement.
- One campus requires the taxpayer to prove that he or she contacted the SSA regarding the stolen identity, and also provide a statement indicating how long he or she has resided at his or her present address. No other campus requires this information. In fact, the IRM instructs IRS employees *not* to refer taxpayers to the SSA but rather to the Federal Trade Commission Identity Theft Hotline.[16]

When applied incorrectly, these procedures harm the rightful owner of the SSN in several ways. The use of a temporary number may cause financial hardship by precluding a taxpayer from claiming the earned income tax credit, child tax credit, or additional child tax credit. The temporary number cannot be used for work purposes, such as providing it to an employer for issuance of Form W-2, Wage and Tax Statement, or any other purpose for which taxpayers normally use their SSNs. Further, unnecessarily subjecting the rightful owner to the scrambled procedures simply compounds the injustice being done that taxpayer.

It is essential that all of the campuses consistently strive to determine the rightful owner of the SSN and use all available means to establish the correct SSN owner, including attempts to contact the lawful owner of the SSN by telephone. Personnel at all campuses

[15] Once the IRS declines to determine which party is entitled to use the number, the IRS keeps the scrambled case file open for 2 years. IRM 21.6.2.4.2.10.

[16] IRM 21.1.3.24(2).

need to understand that scramble procedures produce harsh results for law abiding taxpayers and should be considered an absolute last resort.

(2) Automatic Collection System Levy Release

If a taxpayer is liable to pay any tax but neglects or refuses to pay within ten days after notice and demand, the IRS can levy or seize upon most property and rights to property belonging to the taxpayer. In order to do this, however, the IRS must show that it has satisfied all legal and administrative requirements related to the levy and that the taxpayer has been provided his or her right to appeal the action.[17] Financial accounts, such as checking and savings accounts, wages, or other income of a taxpayer are frequent levy sources. A levy can either be continuous, as in the case of levies on wages,[18] or non-continuous, as in the case of a levy on an account.[19]

The IRS imposes some levies through the Automated Collection System (ACS). When a case is issued to ACS, the ACS system prints a Final Notice of Intent to Levy and Notice of Your Right to a Hearing (Letter LT 11) for mailing by the campus.[20] There must be one attempt to contact the taxpayer before issuing the Final Notice of Intent to Levy, though such contacts are most often via written correspondence.[21] When a delinquent account is not satisfied, the collection process moves forward automatically with the issuance of liens and the levy of assets.

Taxpayers come to TAS for help in getting ACS levies released. The IRS must release taxpayer levies under four different circumstances: the liability is satisfied, the release will facilitate collection, the taxpayer has entered into an installment agreement, or the taxpayer is suffering an economic hardship.[22] The IRS must release property levied upon under any of the following circumstances: if the IRS determines the levy was premature or not in accordance with IRS administrative procedures; if the taxpayer subsequently enters into an installment agreement; or if the return of the property is in the best interest of both the taxpayer (as determined by the National Taxpayer Advocate) and the United States Government (as determined by the Commissioner of the IRS).[23]

[17] IRC § 6331(a); *see* IRC § 6330 for provisions allowing taxpayers the opportunity to appeal the first levy action in a Collection Due Process hearing.

[18] A levy on wages is continuous until released. IRC § 6331(e).

[19] A levy on an account only reaches the amount in the account on the effective date of the levy. Treas. Reg. § 301.6331-1(a).

[20] IRM 5.19.5.3(2).

[21] IRM 5.19.4.3.4(4). The taxpayer is most likely to receive a letter from the ACS sites rather than a phone call. The ACS sites were originally intended to serve as aggressive outbound call centers targeted towards making early attempts to contact taxpayers with delinquent accounts, however, the program has evolved into primarily taking incoming calls. Treasury Inspector General for Tax Administration (TIGTA), Management Advisory Report: *Progress Has Been Made to Consolidate the ACS Workload, but Achieving Employee Skill Specialization Remains an Uncertainty*, Reference No. 2002-30-166, 2 (Sept. 2002).

[22] IRC § 6343(a); Treas. Reg. § 301.6343-1(b).

[23] Treas. Reg. § 301.6343-3(c).

Taxpayers come to TAS seeking a levy release most frequently for economic hardship reasons.[24] TAS case advocates must therefore work with the taxpayer to build a case that the economic hardship exists, so that the levy can be released.[25] TAS has encountered different types of campus inconsistencies in the return of levy proceeds.

An example of inconsistent campus procedures involves the return of levy proceeds taken from a taxpayer after the levy release has been approved but before the release has been processed. TAS case advocates indicate that processing a levy release can take up to 10 days, and the IRS may impose additional levies in the interim, particularly in the case of a continuing wage levy. When this occurs, some campuses compound the taxpayer's problem by requiring the taxpayer to then petition for the return of property, thereby requiring the taxpayer to prove it is in both his or her interest and in the government's interest for the property to be returned. Other campuses return the levied funds recognizing that the levy was caused by the delay in processing. An example of a TAS case is set forth below.

> **Example:** A taxpayer was subject to a wage levy and came to TAS indicating that she was unable to pay for her family's necessities and was informed by the utility company that her electricity was going to be turned off. TAS intervened and asserted that the taxpayer was suffering an economic hardship under IRC § 6343. TAS was able to get the levy released based on the taxpayer's economic hardship, but, before the levy release could be processed, the IRS levied upon additional funds. TAS and the taxpayer were told that these funds would not be returned unless the taxpayer could show it was in the best interests of the taxpayer and the government. Ultimately, the funds were returned to the taxpayer after several weeks of delay.

Taxpayers should not suffer additional hardships caused by IRS processing delays. Once the release of levy is approved, the IRS must expedite the release. If funds are levied in the interim before the levy release is processed, the IRS must recognize that the taxpayer has already proved economic hardship under IRC § 6343 and that levies after the determination have been made are erroneous. The IRS should develop a procedure for inclusion in the Internal Revenue Manual to address this problem.

(3) Audit Reconsiderations

The campus inconsistency related to audit reconsiderations involves both the concept of "substitutes for returns"[26] and the IRS' math error authority.[27] When a taxpayer owes taxes

---

[24] The Taxpayer Advocate Management Information System (TAMIS) reflects that TAS case advocates have submitted 5,601 Operational Assistance Requests (OARs) to the IRS for levy releases in Fiscal Year 2004.

[25] Treas. Reg. § 301.6343-1(b)(4) provides that an economic hardship exists if satisfaction of the levy in whole or in part will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses. The determination as to what constitutes reasonable living expenses is a heavily fact intensive inquiry which analyzes the taxpayer's age, employment status, amount necessary for necessities, child care etc.

[26] IRC § 6020(b).

but does not file a return, IRC § 6020(b) authorizes the IRS to prepare a substitute for the return (SFR) and assess the liability. The Automated Substitute for Return (ASFR) program prepares these returns for the collection function, although the examination function also prepares SFRs separately, using the Report Generating System (RGS). ASFR determines and assesses the tax liability by securing a valid income tax return from the taxpayer or by assessing a substitute for return in accordance with IRC § 6020(b). When a taxpayer does not respond to an IRS contact by filing an original tax return, the IRS computes the tax, penalties, and interest, based upon Information Reporting Program (IRP) information submitted by payers, combined with other internally available information.[28] The IRS then issues a statutory notice of deficiency based upon default filing status, personal exemption, and IRP information.[29] If the taxpayer fails to timely file a petition in the United States Tax Court, the IRS assesses the tax determined by the ASFR system. The collection function will then contact the taxpayer to arrange payment.

Once contacted by the collection function, a taxpayer will often decide to file an original, delinquent tax return seeking a full or partial abatement of the tax assessment. If the IRS denies the request for abatement in full or in part, the IRS is required to send the taxpayer Letter 3340C (Audit Reconsideration Denial).[30] This letter informs the taxpayer that he or she may request a conference with the Office of Appeals.[31] This procedure is followed by Substitute for Return (SFR) units in the examination function at all 10 campuses when there are income disparities between IRP information items and filed tax returns. However, only two campuses currently work ASFR audit reconsiderations, and it is clear that at least one of these campuses is not affording taxpayers due process as required by Letter 3340C. That is, for at least half of the ASFR audit reconsiderations, a denial of abatement requests does not include a notification of the 30-day period within which to request an appeal with the Office of Appeals. Instead, the campus in question treats the omission of income on the original return as a "math error" and issues Letter 474C (Math Error Explained) to the taxpayer. Under certain circumstances, the IRS may summarily assess a math or clerical error without providing deficiency procedures; however, the IRS' math error authority does not extend to this situation.[32] As a result, the taxpayer is not

---

[27] IRC § 6213(b).

[28] For example, the IRS will use a taxpayer's Form W-2 to compute the tax liability. IRM 5.18.1.2(1).

[29] IRC § 6212.

[30] IRM 4.13.3.5.2(1) (Partial/Full Disallowance), providing that (1) If the request for abatement is denied in full or part: a. Send a Letter 3340C to the taxpayer specifying the reason for disallowance; b. for partial disallowance, prepare examination report (Form 4549) and enclose with Letter 3340C. Letter 3340C provides:

> If you disagree with our decision, you may request an Appeals conference by filing a small case request or a formal written protest (depending upon the amount we show you owe), within 30 days from the date of this letter.

[31] Enclosed with the letter is IRS Publication 5, *Your Appeal Rights and How to Prepare a Protest If You Don't Agree.*

[32] The correction to a math error is assessed immediately and the taxpayer has 60 days within which to request abatement. If the taxpayer requests abatement, the IRS must follow deficiency procedures, which provide the taxpayer with the opportunity to litigate the matter in the Tax Court. IRC § 6213(b). The definition of a "math error" has been expanded by Congress. For a detailed discussion of this issue, *see* the *National Taxpayer Advocate FY 2002 Annual Report to Congress*, Most Serious Problem, Math Error Authority, 25-31, and Key Legislative Recommendations, Math Error Authority, 185-197.

afforded the opportunity to go directly to the Office of Appeals as provided for in the Internal Revenue Manual.[33]

TAS has raised this issue with the campus, and TAS is aware that the campus was advised that it should issue Letter 3340C (Audit Reconsideration Denial). Notwithstanding these contacts, the function continues to issue correspondence letters other than Letter 3340C to taxpayers who should be receiving Letter 3340C and the appeal rights to which they are entitled.

CONCLUSION

In this report, TAS has described three inconsistent practices among the IRS campuses that negatively impact the substantive rights of taxpayers: stolen identities, levy releases, and appeal rights under certain audit reconsideration determinations.[34] On other occasions, the National Taxpayer Advocate has identified additional inconsistent procedures at the campuses, such as refund issues (refund trace procedures,[35] refund delete procedures,[36] and manual refund procedures[37]) and tax return processing.[38] In the past, the IRS has been responsive to addressing these inconsistent practices, and the National Taxpayer Advocate has every reason to believe that the IRS will be responsive to the three issues identified in this report. Nonetheless, the scope of the problems identified and the extent to which taxpayer rights are affected by inconsistent procedures suggest that the IRS should pay greater attention to and actively monitor for deviations in procedure between campuses and should place a greater emphasis on national procedures so that similarly situated taxpayers are treated equally.

IRS COMMENTS

As recognized by the Taxpayer Advocate Service, the IRS has instituted nationwide procedures to ensure uniformity in treatment of taxpayer accounts by the campus operations. With ten campuses handling millions of transactions each year, we recognize that instances of inconsistent application of procedures can occur. We have in place extensive mechanisms to identify and address inconsistencies through individual case reviews, campus operational reviews, and functional program reviews. IRS agrees that procedures in working stolen identity cases, ACS hardship levy releases, and Automated Substitute for Return (ASFR) reconsideration issues can be improved or clarified to ensure consistent and timely actions on taxpayer accounts.

[33] IRM 4.13.3.5.2(1).

[34] *See* this report, Most Serious Problem, Collection Statute Expiration Dates, *infra*, for discussion of inconsistent procedures related to collection statute expiration dates.

[35] IRM 21.5.7.

[36] Taxpayer Advocate Service Alert, *Refund Delete* (Oct. 29, 2003).

[37] IRM 21.4.4, Manual Refund.

[38] Taxpayer Advocate Service Alert, Document Processing (Nov. 17, 2003); Taxpayer Advocate Service Alert, Procedures and Requesting a Return Using the Code CC ESTAB (Nov. 17, 2003).

Campuses are not authorized to develop local procedures and should be submitting change requests (a standardized process) when procedures are unclear or missing from the Internal Revenue Manual (IRM). This process provides valuable feedback, identifies specific items needing clarification and allows for procedural modifications to be addressed consistently in the IRM for all campuses. To address the concerns raised by the Taxpayer Advocate Service and to ensure uniform treatment of taxpayers, the IRS will continue to emphasize the importance of procedural consistency, and will continue to monitor adherence in annual Operational and Program Reviews of campus functions.

Stolen Identities

IRS agrees that identity theft is a rapidly growing crime that impacts several IRS tax administration processes, placing significant burden on some taxpayers. To deliver an enterprise approach toward solving identity theft related issues, IRS has designated a Senior Executive to develop an Enterprise Strategy consisting of the following components:

- Enterprise Policy Statement;
- Uniform Processes Resulting in Consistent Taxpayer Treatment;
- Clear and Consistent Communication;
- Documentation Standards to Authenticate Theft; and
- Enabling Legislation to Mitigate Taxpayer Burden.

We have also initiated contacts with the Social Security Administration (SSA) and Federal Trade Commission to collaborate on process improvements and develop consistency in communication and outreach efforts. One of the first steps we have taken toward process improvement was chartering the Scrambled Social Security number (SSN) team. This team has been charged with developing a consistent and streamlined process for managing and resolving Scrambled SSN cases. The new process will focus on reducing lapse time for case resolution, achieving consistency among campus processing and centralizing inventory reporting. This team will also consider local practices/procedures for inclusion in IRM procedures.

Internal Revenue Manual (IRM) 21.6.2.4.2.2 contains procedures for situations where different taxpayers utilize the same SSN. These "Scrambled SSN" procedures were developed to address cases where SSA inadvertently assigned the same SSN to more than one individual. The procedures were not developed or intended for identity theft cases. It is important to note that not all Scrambled SSN cases are identity theft cases, or vice versa. Furthermore, SSA has the responsibility for determining who is the rightful owner of the SSN. Once the determination is made, all accounts are appropriately adjusted.

The IRS has already taken several actions to correct the identify theft issues identified. This includes conducting train-the-trainer sessions by Accounts Management

Headquarters in September 2002 for representatives from all sites/functions working Scrambled SSN cases. Accounts Management Headquarters staff also completed review of Scrambled SSN cases in several campuses. Four reviews were conducted in Fiscal Year (FY) 2003, and three follow-up reviews occurred in FY 2004. The reviews included verification that procedures were followed, thorough review of open and closed cases, focus group interviews with employees, and interviews with managers regarding the process. The reviews revealed only a few instances of IRM deviation and inconsistencies, all of which were reported to the respective campus director for his/her action. IRM 21.6.2.4.2.2 was also revised to send a second Letter 239C when a response is not received from either taxpayer.

Automated Collection System Levy Release

IRS agrees that procedures can be clarified to address inconsistencies in refunds of levy proceeds. If subsequent levy payments are received because of a delay in a hardship levy release (after hardship has already been determined by the IRS), the IRS should refund those levy proceeds. We will work to clarify the procedures to include examples of when to refund levy proceeds received after determination and issuance of a hardship levy release.

Audit Reconsiderations

IRS agrees that inconsistencies previously existed in Automated Substitute for Return (ASFR) reconsideration processing when there was unreported income on delinquent returns filed after an ASFR assessment. Those problems were corrected during FY 2004 as part of an overall initiative to improve ASFR current processes. To monitor adherence to IRM procedures, IRS plans to specifically review ASFR reconsideration processing during FY 2005.

We will take the steps described above to address these examples of inconsistencies and will continue to closely monitor adherence to procedures.

TAXPAYER ADVOCATE SERVICE COMMENTS

The IRS' response to the issues raised in this section of the report is encouraging. The IRS has been responsive to the problem of campus inconsistency, devoting executive level attention and responsibility to the issue. The high volume of IRS work makes the goal of campus consistency challenging, and we look forward to working with the IRS on campus procedure issues. In order to effectively address current and future inconsistent campus procedures, the National Taxpayer Advocate makes the following recommendations.

RECOMMENDATIONS

With respect to the three inconsistent practices identified in this analysis, the following recommendations are made.

In the case of stolen identities, the IRS should:

- *Revise the IRM to require multiple attempts at person-to-person contact via telephone with each taxpayer using the SSN;*
- *Revise the IRM further to provide that scrambled procedures should be utilized only after phone contact is attempted with the SSN users, and only in those cases where available information clearly supports use of the SSN by both taxpayers; and*
- *Standardize procedures as to what information is required from taxpayers complaining of stolen identities.*

In the case of audit reconsiderations:

- *At least one campus is not following the IRM and is not affording taxpayers the opportunity to have their cases heard before the Office of Appeals, and the IRS needs to take immediate corrective action.*

With respect to addressing future inconsistencies, consistency among the campuses could be improved if the following steps are taken:

- *Identifying a responsible official for investigating inconsistent campus procedures IRS-wide for each of the three campus functions (submissions processing, account management and compliance). When an inconsistent procedure has been identified, he or she could issue an alert to all IRS offices reminding them of the correct procedures.*
- *Establishing a portal on the IRS Intranet for use by employees who become aware of inconsistencies so that they have a means of bringing the issue to the attention of the responsible official; and*
- *Performing follow-up audits on incorrect campus procedures to ensure that corrections have occurred.*

In effect, these recommendations would establish a "pipeline" from the lowest to the highest levels for raising and resolving issues of inconsistency in procedures or tax law interpretation between all IRS offices. These recommendations would also result in a decrease of taxpayer burden by ensuring equitable treatment of all taxpayers and a corresponding increase in customer satisfaction, employee satisfaction, and business results.

PROBLEM TOPIC C-10 — MOST SERIOUS PROBLEM: PROCESSING ITIN APPLICATIONS AND AMENDED RELATED FEDERAL INCOME TAX RETURNS

RESPONSIBLE OFFICIALS:

Henry O. Lamar, Jr., Commissioner, Wage and Investment Division
Kevin M. Brown, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEMS

Taxpayers often encounter problems related to IRS processing problems. This year the National Taxpayer Advocate is focusing on two areas where IRS processing problems are having a significant negative impact on taxpayers: the processing of applications for Individual Taxpayer Identification Numbers (ITINs) and the processing of amended tax returns.

- **ITIN Application Problems** - The IRS issues Individual Taxpayer Identification Numbers (ITINs) to individuals who are not eligible to receive Social Security Numbers (SSNs), yet need an identification number for tax administration purposes.[1] The taxpayers that need ITINs are primarily foreign taxpayers who are the least able to navigate the IRS. Concerns regarding timely processing of ITIN applications were previously raised in the National Taxpayer Advocate's 2003 Annual Report to Congress.[2] ITIN processing remains a Most Serious Problem because previously identified problems persist and many additional problems have been identified, including:
  1. delays in processing tax returns filed with ITIN applications;
  2. failure to process extension requests submitted by ITIN applicants;
  3. inconsistent assistance provided to taxpayers with ITIN applications by Taxpayer Assistance Centers (TACs); and
  4. issuance of ITIN notices in the wrong language.
- Amended Return Problems -Taxpayers are also experiencing problems related to the IRS processing of amended returns. When taxpayers file amended returns, they are often seeking to lower their tax liability, which may result in a tax refund. The problems that taxpayers have experienced have primarily related to delays in receiving their refunds. In fiscal year 2003, TAS received over 18,500 cases in which the primary issue involved delay in the processing of amended tax returns.[3]

ANALYSIS OF ITIN PROCESSING PROBLEMS

On December 17, 2003, the IRS announced significant changes to the ITIN application process.[4] Applicants can now apply for an ITIN only when they have a valid filing

---

1 Treas. Reg. § 301.6109-1(d)(3).

2 National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Revision 12-2003) 77-83.

3 The TAS receipts were extracted from the Taxpayer Advocate Management Information System (TAMIS) for FY 2003 with a Primary Core Issue Code (PCIC) of 330, Processing Amended Returns. A total of 18,518 cases for individuals and business taxpayers were identified.

4 IRS News Release, "IRS Announces Revisions to ITIN Applications," IR-2003-140, (December 17, 2003).

requirement and file an original valid federal tax return with their Form W-7/W-7SP (Application for IRS Individual Taxpayer Identification Number), unless they meet one of the exceptions to the requirement to attach a U.S. tax return.[5] Previously, a taxpayer could apply for an ITIN in advance to ensure that he or she received a number from the IRS before filing a return.[6] Before reporting on the problems affecting taxpayers in this area, it is necessary to set forth the current procedures for processing ITIN applications.

Current ITIN Processing Procedures

The IRS has recently created a two-step process for filing an ITIN application, under which tax returns are not processed until all ITIN applications associated with the filed returns have been processed. In the first step, the IRS reviews ITIN applications to ensure that they are complete, with all necessary supporting documents attached. Supporting documentation must verify the applicant's identity, include a photograph, and be either an original or a copy certified by the issuing agency. With each tax return, a family can file multiple ITIN applications, which in IRS parlance are referred to as "family packs." The family packs must be kept together during ITIN application processing, for if one is separated or lost it will affect the processing of the tax return.

ITIN applications are also reviewed to determine if valid tax returns are attached, unless the applicant meets one of the exceptions.[7] Processing the return is considered the second step in the process. If the ITIN application is incomplete or the return is missing or invalid, the application is returned to the applicant with a notice explaining why the application cannot be accepted as filed. In the calendar year 2004, the IRS received 1.29 million applications, 900,165 with tax returns attached and 399,097 without.[8] Under the revised procedures, if the applicant does not submit a return with the application or if the return is incomplete, the ITIN unit will reject the application and return it to the applicant unless he or she meets one of the exceptions for requesting an ITIN without filing a tax return.[9] In the calendar year 2004, the IRS returned 274,778 Forms W-7 to applicants for not filing returns with their applications and rejected 37,513 applications because the returns were incomplete.[10]

[5] IRS Publication 1915, *Understanding Your IRS Individual Taxpayer Identification Number* (Rev. 2004).

[6] Applicants who are not required to pay income tax but need an ITIN for a purpose other than filing an income tax return, such as to take advantage of a tax treaty or for other specified purposes, may still apply for an ITIN at any time throughout the tax year. IRS Publication 1915, *Understanding Your IRS Individual Taxpayer Identification Number* (Rev. 2004).

[7] The exceptions for filing a tax return are listed in the instructions on the Form W-7. The exceptions include: (1) foreign taxpayers who own an asset that generates income tax withholding or an information return requirement, such as owning a bank account or partnership interest, (2) foreign students or scholars receiving pay for personal services, (3) foreign borrowers receiving mortgage interest reports, and (4) foreign taxpayer who sells property and is subject to withholding requirements. *See* Form W-7 Instructions, p.3.

[8] Calendar Year 2004 ITIN Processing Data Report through Sept. 24, 2004.

[9] *See* Form W-7 Instructions, *supra*.

[10] Calendar Year 2004 ITIN Processing Data Report through Sept. 24, 2004.

If a valid tax return is received with an incomplete application, the IRS suspends the application and sends the applicant a notice requesting the required information, then sends a second notice if the applicant does not respond.[11]

An application that remains in suspense for more than 75 days with no response will be rejected. The IRS will then process the return for the primary taxpayer with a temporary number and hold any potential refund.[12] If the ITIN applicant is a spouse or dependent, the exemption(s) claimed on the return will be disallowed and a math error notice issued.[13]

(1) Delays and Other Problems in Processing Tax Return Associated with ITIN Application

The new two-step ITIN application procedures provide what amounts to a built-in delay in handling tax returns, which cannot be processed until the ITIN application is processed. The IRS advises applicants that it takes four to six weeks to process a Form W-7 and at least six weeks for a return.[14] If a taxpayer applying for an ITIN is also entitled to a refund, it will take at least 10 to 12 weeks to process both the ITIN application and the tax return, assuming there are no other delays.

In its response to the National Taxpayer Advocate's 2003 Annual Report to Congress, the IRS committed to processing ITINs within two weeks' time.[15] While the IRS was not able to provide TAS with its own indication of the average processing time of ITINs, a review of TAS ITIN cases reflects an average of 39 days.[16] The IRS does not appear to have

[11] IRM 3.21.260.5.19 (December 15, 2003).

[12] To constitute a sufficient claim for refund, the income tax return must set forth the amount determined as an overpayment and should advise the IRS whether such amount shall be refunded to the taxpayer or shall be applied as a credit against the taxpayer's estimated income tax for the succeeding year. Treas. Reg. § 301.6402-3. However, the IRS takes the position that even though a tax return may be sufficient for processing it is not required to pay out the refund if it cannot establish the correct ITIN or SSN. IRS SCA 20023003, dated June 13, 2002. In such a case, an IRS temporary number is assigned to avoid further delays in the internal processing of a tax return or payment. The refund will not be released until the taxpayer submits sufficient information/documentation to secure an ITIN.

[13] Taxpayers that make "math errors," as that term is defined in IRC § 6213(b), are treated differently than other taxpayers with deficiencies in that they are subject to summary assessment without the immediate right to go to the U.S. Tax Court. IRC § 6213(b). Instead, taxpayers that have made math errors have 60 days to request abatement of the tax. If the taxpayer requests abatement, the IRS must abate the tax but can reassess the tax using the deficiency procedures. The National Taxpayer Advocate has criticized the expansion of math error authority because the procedure and notices are confusing to taxpayers, particularly low income taxpayers, and too often taxpayers fail to adequately assert their appeal rights. National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002).

[14] IRS Form W-7, *Application for the IRS Taxpayer Identification Number* (Rev. 12-2003) and IRS 2003 1040 Instructions, 11.

[15] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 79.

[16] This is not to suggest that the average processing time for all ITINs during the 2003 filing season was 39 days. TAS only sampled ITIN cases of taxpayers who came to TAS with a problem. TAS provides this figure, however, as the only available information.

achieved its two week goal, but it has improved processing time for Forms W-7.[17] At the same time, the two-step process has caused numerous delays to tax return processing and has created other problems. To identify the processing time for an ITIN application and the related tax return, TAS analysts reviewed a sample of TAS cases involving Forms W-7 issues.[18] On average it took 39 days to process the tax return on the TAS cases sampled. Overall, it takes a minimum of 11 to12 weeks for the entire two-step process. In contrast, the average processing time for an original paper filed return is four to six weeks; electronically filed returns take three weeks to process; and e-filed returns where a direct deposit is requested can take as few as 10 days.[19] Therefore, taxpayers who are required to file a Form W-7 with a tax return must wait an additional four to six weeks for their refunds because of the two-step process.

Other processing problems related to the two-step process were detected as well. During the 2004 processing year, taxpayer representatives complained that tax returns were detached from ITIN applications before they reached the ITIN unit and that multiple ITIN applications from families were separated from the package.[20] When an ITIN application is erroneously detached from the accompanying tax return and the primary taxpayer has no ITIN or SSN, the Form W-7 is sent back to the applicant with a notice asking for the required valid return.[21] If the primary taxpayer has an ITIN or SSN, the IRS will process the tax return but will disallow any exemptions claimed for a dependent or spouse without an identifying number under IRC section 6213(b) math error procedures.[22] In other words, when an ITIN application is separated from a tax return, an incorrect tax liability may result, requiring taxpayers who are often the least able to navigate the IRS due to language and other barriers to resolve this IRS-created problem.

[17] Information identified from the sample of TAS cases indicates that prior to December 17, 2003, it took on average 90 days to process the Form W-7. Under the revised procedures, it takes 39 days to process the ITIN application. This equates to a difference of 51 days or a 57% percent improvement over the pre-December 2003 process. It does take longer for processing ITIN applications when they are suspended during the process. On average it took 57 days to assign the ITIN on suspended applications compared to 34 days when there was no suspension.

[18] The TAS receipts were extracted from the Taxpayer Advocate Management Information System (TAMIS) for cases received January 1, 2004 through April 30, 2004 with a Primary Core Issue Code 450, Form W-7/ITIN/ATIN. A sample of 244 TAS cases was reviewed based on a population size of 588 cases. Applications filed for ATINs or PTINs were not included in the review. The sample was based on a 95 percent confidence rate plus or minus 5 percent.

[19] IRS 2003 Form 1040 Instructions, 56.

[20] One Low Income Taxpayer Clinic informed TAS that 75 percent of its ITIN applications are being erroneously returned to them with a letter stating that the application was received without a tax return attached when in fact tax returns had been attached.

[21] Notice 1051, *Form W-7, Application for IRS Individual Taxpayer Identification Number (ITIN)*, is generally used to (1) send back original documentation to the applicant after the application is processed, (2) request additional information or documentation, when applicable, or (3) send the entire package back to applicant when he or she has not submitted the required tax return or substantiating documents proving his or her need for the ITIN or when an invalid tax return is submitted with the Form W-7/W-7SP.

[22] IRC § 6213(b).

During 2004, TAS also received complaints from taxpayers who did not receive their refunds after filing ITIN applications with tax returns.[23] When TAS intervened on behalf of these taxpayers, it turned out that the IRS often had conflicting indications as to whether a return was received. The return processing unit had no record of the return while the ITIN database reflected a return was received with the application. Several of these returns were later found attached to the processed ITIN applications in files, and had not been detached and forwarded for processing. In other cases researched by the ITIN unit, although the primary taxpayer was notified that an ITIN was assigned, the return could not be processed until all ITIN applications submitted with it were either assigned a number or rejected. In still other instances, the separation of ITIN applications from "family pack" applications delayed return processing if one or more Forms W-7 was suspended. An example of a typical TAS case is provided below:

> **Example:** A taxpayer who had an SSN filed a family pack of ITIN applications (Forms W-7) with his return (Form 1040). The forms were separated during processing because the Forms W-7 did not have the proper documentation, and the IRS processed the tax return but returned the unprocessed Forms W-7 to the taxpayer. The taxpayer sent back the corrected Forms W-7 but the IRS rejected them again because a Form 1040 was not included, even though the IRS had already processed the taxpayer's Form 1040. Eventually, TAS intervened for the taxpayer, but his refund was substantially delayed.

In sum, it appears that with the two-step process the IRS has cured one delay (the processing of ITIN applications) at the expense of another (the processing of tax returns). Unfortunately, the tradeoff is not tax neutral to the taxpayer who must now wait longer for his or her refund. Problems also occur when tax returns and ITIN applications were incorrectly separated. An additional problem caused by the two-step process, the destruction of tax return extension requests, is described below.

(2) Failure to Process Tax Return Extension Requests When ITIN is Needed.

The two-step process for ITIN applications also created problems for taxpayers requesting extensions of time to file returns. Taxpayers are entitled to one automatic extension, which they request on Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Tax Return), and may be granted a second extension (filed on Form 2688, Application for Additional Extension of Time to File U.S. Individual Tax Return) at the discretion of the IRS. When a taxpayer needs an extension but does not yet have an

[23] The TAS case receipts were extracted from the Taxpayer Advocate Management Information System (TAMIS) for cases received in FY 2004 with a Primary Core Issue Code 310 (Processing Original Return) and a Secondary Core Issue Code 450 (Form W-7/ITIN/ATIN). A total of 285 cases were identified, however, this number may be understated because these codes were not required to be entered into TAMIS until September 1, 2004.

ITIN, Publication 1915, Understanding Your IRS Individual Taxpayer Identification Number, tells him or her:

> If you are filing for an Extension of Time to File United States Income Tax Return (Form 4868 or Form 2688) or making an estimated payment with these forms or Form 1040-ES (Estimated Tax for Individuals) or Form 1040-ES (NR) (Estimated Tax for Nonresident Aliens), **do not file the Form W-7/W-7SP with these forms. Write "ITIN TO BE REQUESTED" wherever the ITIN or SSN is requested**. An ITIN will be issued only after you have filed a valid income tax return and met all other requirements. [emphasis added][24]

Despite these instructions, the unit responsible for processing extension requests was directed not to process this type of extension request because they did not have a taxpayer identification number.[25] This is obviously in conflict with the directions given to taxpayers in IRS Publication 1915. The IRS tracks all taxpayer information by reference to either an SSN or an ITIN, and therefore must assign a number to a taxpayer to register that taxpayer's extension request. Rather than assigning temporary identification numbers or mailing the extension requests back to the taxpayers (or notifying them in some other way), the processing unit destroyed many taxpayer extension requests during the 2004 filing season. The unit acknowledged numerous cases where taxpayers without ITINs filed the Form 4868 and followed instructions by writing "ITIN to be requested" in the SSN and ITIN box, only to have the request destroyed by the IRS without the taxpayer's knowledge. The destruction also means that TAS cannot follow up with these taxpayers to determine whether or not they were assessed penalties for failure to file.

When TAS learned that taxpayers in need of ITINs and extensions were being told to file extension requests without the ITIN application, only to have the IRS destroy the requests as "non-processable," TAS engaged the processing unit in a dialogue in an attempt to ensure that no future taxpayer filings were treated this way. In the case of Form 2688 (the discretionary extension) submissions, the processing unit has committed to mailing back a response to the taxpayer, but the unit has no plans to treat Form 4868 extension requests any differently than in 2004. The unit will presumably continue to destroy these forms, and taxpayers will not be notified that their requests were not processed. The only difference in treatment between Form 2688 and Form 4868 is that the former requires some response from the IRS because that extension request is discre-

[24] IRS Publication 1915, *Understanding Your IRS Individual Taxpayer Identification Number*, 4 (Rev. 2004).

[25] The IRM provides:

> Form 4868 only – if the taxpayer has made a notation that an ITIN will be applied for, treat the extension request as unprocessable. **Give it to your manager for preparation for destruction**. IRM 3.11.212.2.2(3) (8-9-04). (emphasis added).

tionary while the latter is supposed to be automatic. Of course, Form 4868 does not produce an automatic extension for ITIN applicants because the requests are destroyed before they can be processed.

These taxpayers, then, will be subjected to penalties for failure to timely file returns, despite the fact that they followed IRS procedures. It is difficult to conceive of a more frustrating scenario for a taxpayer than to follow IRS instructions and then be penalized for doing so. The IRS must instruct the taxpayer as to what it wants him or her to do and then have processes in place to handle the taxpayers' submissions. As of this date, the IRS has no plans to revise Publication 1915, and the processing unit has no plans to revise its procedures when automatic extension requests come in without an identifying number. However, solutions to the problem are readily available. The preferred option is to assign temporary identification numbers to taxpayers so that their extension requests will be processed, which would at least be consistent with the instructions in Publication 1915. Alternatively, the IRS could accept Form W-7 applications with the original extension requests, and require that documentation showing a valid tax purpose, e.g. a copy of a Form W-2 or Form 1099, be attached to the ITIN application.

3. Inconsistent Taxpayer Assistance From Taxpayer Assistance Centers.

Taxpayer Assistance Centers (TACs) are IRS-staffed centers, located in all 50 states, where taxpayers can pick up forms and publications, seek guidance about tax laws, request transcripts in emergency situations, request account information and adjustments.[26] TAC employees are required to help taxpayers with ITIN applications and supporting documentation in the following ways:

- Assist with preparation of Form W-7/W-7SP;
- Verify supporting documents, if appropriate;
- Photocopy identification documents and attach them to the Form W-7/W-7SP when forwarding them to the IRS' Philadelphia campus for processing with the completed tax return;
- Review the return to ensure it is signed, the addresses on the Form W-7/W-7SP and the return match, and the return demonstrates income; and
- Mail the completed Form W-7/W-7SP packet to the ITIN unit in Philadelphia.[27]

Unfortunately, not all TACs review or validate Forms W-7 as required. TAS has identified instances where a TAC sends along incomplete ITIN packages, which the ITIN processing unit will either reject or suspend while awaiting additional information. It is particularly

[26] IRS, *Field Assistance Concept of Operations*, 2 (Aug, 3, 2001).

[27] IRM 21.3.4.20.1 (Rev. June 27, 2003) (serpedit March 17, 2004).

frustrating for taxpayers to submit their ITIN applications to a TAC believing that all requirements have been satisfied, only to receive a rejection letter from the ITIN processing unit. There also appears to be a problem in shipping Forms W-7 from TACs to the ITIN unit. Over a four month review period, TAS received 14 cases where ITIN applications filed with a TAC were never processed. In nine of those cases, the Philadelphia ITIN processing unit never received the packages. In five other cases, the TACs did not properly review and validate the documents, resulting in rejected ITIN applications.[28]

4. Miscellaneous Problems with ITIN Processing

TAS has detected numerous other problems associated with ITIN application processing, including:

Acceptance Agents

In 1996, the IRS created "Acceptance Agents" to facilitate the ITIN application process by reviewing and forwarding the taxpayer's completed Form W-7 (together with the required documentary support) to the IRS.[29] There are currently 1,909 acceptance agents in the program.[30] All acceptance agents sign an agreement with the IRS that allows them to fax applications directly to the ITIN unit if the numbers are needed immediately. Under current procedures, however, since the applicant is required to submit an original tax return (if no exception is met), applications with returns cannot be faxed for expedited processing.[31] The IRS had also agreed to send the acceptance agent a copy of the notice issued to the applicant with his or her assigned ITIN. At present, the database used to process ITINs and generate notices cannot provide copies to agents. The IRS is changing the administration of the Acceptance Agent Program and has stopped accepting new applications for the program pending issuance of new procedures.[32]

Original Documents

The IRS instructs taxpayers to submit with the ITIN application "original documents, or certified or notarized copies of documents that substantiate the information provided on Form W-7."[33] These documents include drivers' licenses, visas and birth certificates, certified or notarized copies of which are often difficult or impossible for foreigners to obtain in this country. For example, most notaries can only certify that an individual's signature

[28] *See* TAMIS case review, *supra*, note 18.

[29] Certified Acceptance Agents can certify to the IRS that the documents are authentic, complete and accurate and forward only the certification and W-7 form to the IRS. The certifying agent is required to maintain a record of the documentation for a definite period of time. The certifying agent must agree to submit supporting documents to IRS upon written request. Rev. Proc. 96-52, 1996 C.B. 372.

[30] IRS ITIN 2540 Report, dated Oct. 1, 2004.

[31] IRS, *Alert for Acceptance Agents*, IRS e-News for Tax Professionals – Pennsylvania, July 13, 2004, Issue 2004-07.

[32] IRS, "International Taxpayer – How to become an Acceptance Agent for the IRS ITIN Numbers," at http://www.irs.gov/businesses/small/international/article/0,,id=96671,00.html.

[33] IRS Form W-7, Instructions, 2. (Rev. Dec. 17, 2003).

is authentic, not that documents are authentic copies. As a result, ITIN applicants frequently send original identification materials with their ITIN applications, and too often these valuable documents are separated from the applications and lost. The IRS should discourage the submission of original identification documents and work to find an acceptable and workable substitute for ITIN applicants.

ITIN Notices in Incorrect Language

The ITIN processing unit continues to issue Spanish notices to English-speaking applicants and English notices to applicants who filed a Form W-7SP (the Spanish version). The ITIN database identifies a Spanish form by the way it is numbered.[34] If the form is erroneously numbered as Spanish, the unit issues the applicant a notice in Spanish. Taxpayers have complained to TAS about receiving ITIN notices in the wrong language. This processing problem appears to occur because IRS personnel assign an incorrect number to the Form W-7/W-7SP which is then input to the database. This confusion leads to unnecessary contacts between the taxpayer and IRS as the taxpayer attempts to clarify the situation. The IRS needs to better train and educate its workforce about the consequences of erroneously assigning an incorrect document locator number to ITIN applications.

ANALYSIS OF AMENDED RETURN PROCESSING PROBLEMS

In addition to the difficulties affecting ITIN applications, there appear to be systemic problems within the IRS in processing amended tax returns. In calendar year 2002, taxpayers filed approximately 3.5 million Forms 1040X, Amended U.S. Individual Income Tax Return.[35] Taxpayers are told it can take two to three months to process Form 1040X,[36] and they often contact TAS for assistance when returns are not processed timely. In fiscal year 2003, TAS received over 18,500 cases in which the primary issue involved amended return processing.[37] Processing of amended returns is ranked as the number two major issue involving TAS cases for fiscal years 2003 and 2004.[38] As Table 1.10.1 shows, TAS reviewed a sampling of its amended return cases and found that 82 percent involved Form 1040X.[39]

34 IRM 3.21.260.5.3 (April 12, 2004).

35 IRS, *Projections of Returns That Will be Filed in Calendar Years 2004-2010*, Statistics of Income Bulletin, Winter 2003-2004, April 2004, Table 1.

36 Instructions for Form 1040X, Amended U.S. Individual Income Tax Return.

37 *See* TAMIS results, *supra*.

38 *See* TAMIS results for FY 2003, *supra*. TAMIS results for FY 2004 reflect 11,180 cases where Primary Core Issue Code was 330, Processing Amended Returns.

39 The TAS receipts were extracted from the Taxpayer Advocate Management Information System (TAMIS) for FY 2003 with a Primary Core Issue Code of 330, Processing Amended Returns. A sample of 384 TAS cases was reviewed based on a population size of 18,239 cases for individual and business taxpayers (excluding Large and Mid-size businesses). The sample was based on a 95 percent confidence rate plus or minus 5 percent.

TABLE 1.10.1, TAS AMENDED RETURN PROCESSING CASES

Individual Tax Return Related Forms Filed (91%)		
Form	**Number Reviewed**	**Percent of Total**
1040X, Amended U.S. Individual Income Tax Return	316	82%
8379, Injured Spouse Claim and Allocation	33	9%
Business Tax Return Related Forms Filed (9%)		
Various business tax forms	35	9%

Additionally, Table 1.10.2 shows the top 10 reasons taxpayers are amending their returns. Family status related issues, e.g. earned income tax credit, dependency exemptions, filing status and child tax credits, constitute approximately 32 percent of the top ten individual amended tax return cases. Many of these amended returns involve the earned income credit and other benefits that assist low income taxpayers who use the refunds for basic living expenses. Delays and mistakes in processing can seriously impact these taxpayers.

TABLE 1.10.2, TOP TEN ISSUES ON INDIVIDUAL AMENDED RETURNS

Issues	Volume	Percentage
Earned Income Credit - Dependents - Head of Household - Child Tax Credits	76	32%
Injured Spouse	33	14%
Schedule A &/or Form 2106	29	12%
Wages/Other Income/Adjusted Gross Income	29	12%
Schedule E (1120S & 1065)	18	7%
Married Filing Jointly	16	7%
Loss Carrybacks	13	5%
Schedule C	11	5%
Pensions & Annuities	8	3%
Tax Credits (Education Credit)	8	3%
Totals:	**241**	**100%**

When the IRS' Submission Processing function receives a Form 1040X, it is screened to determine if additional review is needed before allowing the requested change to the original return. All non-technical amended returns (those where determination of the taxpayer's entitlement to the refund or other relief is evident from material available to the reviewer) are coded for processing without further review. In calendar year 2003, over one million non-technical Forms 1040X were adjusted directly through the 1040X function in Submission Processing.[40] Although this allows the IRS to process amended returns and issue refunds more quickly, it can cause problems for taxpayers if the IRS misplaces or loses

[40] W&I Submission Processing 1040X Receipts and Production Report, 01/01/2003 – 12/26/2003.

the amended return, because it sends no acknowledgement of receipt when an amended return is filed. Sixty-nine percent of TAS cases involving amended return processing were due to either the taxpayer experiencing a delay of 30-plus days over normal processing time or not receiving a response or resolution by the date promised by the IRS.[41]

If a Form 1040X needs additional review, special coding must be placed on the taxpayer's account indicating an amended return was received, the date it was received, and where it was forwarded for processing.[42] An unprocessable amended return will be rejected and returned to the taxpayer with a letter requesting the missing information.[43] In this instance, special coding is input to show that the amended return was rejected, enabling the IRS to track the return until it is processed. Unfortunately, this coding is not always added or updated when required. Of the 392 tax periods reviewed in the analysis of TAS cases, 92 or 23 percent had no indication in the account that an amended return was received.[44] When the IRS has no record of receiving an amended return, the taxpayer has the burden of submitting proof by reconstructing or resubmitting the amended return.

When Submission Processing determines that an amended return requires additional review, the claim is forwarded to the appropriate IRS function for processing. In calendar year 2003, over 2.1 million individual amended returns were sent to various functions.[45] When these returns are routed, delays in processing can occur. For example, if an amended return is selected for audit, the IRS sends the taxpayer a letter explaining that the refund may be delayed while the claim is examined.[46] The analysis of TAS cases showed that 36 percent of the amended returns reviewed by the functions were referred to Examination.[47] While amended returns not requiring Examination scrutiny took an average of 153 days to process, those with Examination involvement averaged 264 days, or 73 percent longer.[48]

[41] IRM 13.1.7.2. TAS case criteria codes five and six – 69 percent plus or minus 5 percent with a 95 percent confidence rate.

[42] IRM 3.11.6.3.7.

[43] A processable return is a return filed on a permitted form (including required attachments, supporting documents, and schedules), contains sufficient required information to permit the mathematical verification of the amount shown on the claim, and contains the name, address, and the taxpayer's identification number and is signed by the taxpayer(s) or authorized representative under penalties of perjury. An unprocessable return will not be returned to the taxpayer if it has been assigned a Document Locator Number, involves a tax increase, or involves a tax decrease where the Statute of Limitations will expire within the next 120 days. The return is held in suspense awaiting a response from the taxpayer. IRM 21.5.3.4(3).

[44] Several of the 384 accounts reviewed involved multiple tax periods. Those tax periods that did not have an indication of an amended return being received equates to 23 percent plus or minus 5 percent with a 95 percent confidence rate. TAMIS review of PCIC 330 FY 2003.

[45] W&I Submission Processing 1040X Receipts and Production Report dated 01/01/2003 – 12/26/2003.

[46] IRM 21.5.3.4.7.2(4).

[47] There were 138 individual taxpayer accounts identified as having Examination involvement or 36 percent, plus or minus 5 percent with a 95 percent confidence rate. TAMIS review of PCIC 330 FY 2003.

[48] The average days were computed based on those accounts where the timeframes could be established for cases with Examination involvement and those without. TAMIS review of PCIC 330 FY 2003.

Because of the volume of returns and insufficient examination staff, amended returns are often "shelved" until resources are available to work them. TAS case advocates utilize Operational Assistance Requests (OARs) to request an expedited review of returns when refunds are delayed for an unreasonable time.[49] The operating divisions are required to respond to OARs by Internal Revenue Manual provisions and written agreements with TAS. Still, TAS case advocates have reported instances where no Examination group managers were available to even accept an OAR on a delayed refund case. An example is set forth below.

> **Example:** A taxpayer who was homeless and in need of cancer treatment came to TAS in June 2003 seeking help in obtaining a substantial refund from an amended return filed in April 2002. When TAS intervened, the case advocate discovered Exam had selected the return for audit but subsequently lost the file. Despite multiple calls from the advocate and promises from the manager, no progress was made. Eventually, the case was assigned to a revenue agent who agreed to expedite the refund. The taxpayer received it two and one-half years after filing the amended return.

Part of the problem within the units responsible for processing amended returns is the same one existing throughout the Internal Revenue Service: competition for scarce resources. However, delays in processing not only adversely impact the taxpayer but the IRS as well, in the form of increased interest payouts on overpayments and wasted resources applied to unnecessary calls and correspondence resulting from taxpayer attempts to resolve the problem. Overpayments resulting from a processable claim for refund or amended return are not entitled to interest if the refund is issued within 45 days after the claim is filed.[50] If the return is filed after the last allowable date for filing the return, no interest is paid on the refund if the amount is paid within 45 days from the date that the return is received by the IRS.[51] However, since amended returns often take two to three months to process, most overpayments accrue interest. For example, taxpayers whose overpayments were identified by IRS examinations or amended returns received $3.2 billion of the total $3.5 billion of interest paid by the IRS in fiscal year 1999.[52] In contrast, taxpayers claiming overpayments on original tax returns received only $0.1 billion in interest in FY 1999.[53] During the review of a sample of TAS cases involving amended return processing, interest of $191,322 was issued on overpayments totaling approximately $1.6 million on

[49] IRM 13.1.3.1.

[50] IRC § 6611(e).

[51] *Id.*

[52] Treasury Inspector General for Tax Administration (TIGTA), *Tax Law Changes Are Needed to Improve Fairness in Paying Interest on Tax Refunds*, Reference No. 2001-30-148, 7 (Sept. 2001).

[53] *Id.*

individual accounts.[54] Thus, the IRS should consider utilizing interest paid on amended return refunds as a diagnostic measure for the return processing units.

Another cause of delays in amended return processing appears to be an institutional attitude within the IRS about its own delays and processing errors. There may be no better example of the prevailing IRS attitude towards its own internal delays and mistakes in the amended return area than the case of *Palihnich v. Commissioner*.[55] In *Palihnich*, the IRS lost the taxpayer's amended returns for 11 years. After numerous letters from the taxpayer over this period, the IRS finally located and processed the amended returns and actually sought to collect interest attributable to the 11 years when the returns were missing. The taxpayer asserted that the interest should be abated under IRC section 6404 in light of IRS errors in handling the amended returns. The IRS took the position that the taxpayer was at fault. The U.S. Tax Court ruled that the IRS had abused its discretion in failing to abate the interest, noting:

> Petitioners had no role in losing their 1981 – 1982 returns for 11 years and deserve credit for bringing respondent's attention to the fact that the respondent had lost those returns.[56]

When the IRS loses a return for 11 years, yet continues to fight the taxpayer in court over related interest, it sends the wrong message about its responsibility to effectively process and administer amended returns. In light of the positions taken by the IRS in *Palihnich*, a rational taxpayer could wonder: *what chance do I have of getting my processing delay corrected when the IRS blames taxpayers for its own mistakes?*

CONCLUSION

There appear to be systemic processing problems within the ITIN and amended return processing units. These units receive high volumes of taxpayer submissions, but in dealing with these volumes, they have also adopted processes that impact negatively on taxpayers. In the case of ITINs, the new two-step process for ITIN filings has caused a number of problems, including built-in delays and the destruction of certain taxpayer submissions. While reducing processing time is important, it is disturbing that these units have elevated cycle-time concerns over safeguarding submissions. A more effective means of eliminating cycle time could be the elimination of the two-step process. In the case of amended returns, TAS received over 18,500 cases relating to amended return processing, usually involving substantial delays in tax refunds. In addition to these delays, a number of cases demonstrate that taxpayers with hardship cases had difficulty penetrating the IRS

[54] TAMIS review of PCIC 330 (amended return code), FY 2003. There were 188 refunds issued on individual accounts out of a sample of 384 TAS cases reviewed for individual and business taxpayers (excluding Large and Mid-size businesses). The sample was based on a 95 percent confidence rate plus or minus 5 percent.

[55] *Palihnich v. Commissioner*, T.C. Memo. 2003-297.

[56] *Id.*

bureaucracy without help from TAS. When developing new procedures and establishing performance criteria for existing criteria, the IRS must give more thought and appreciation to the impact on taxpayers and allocate the appropriate level of resources necessary to solve taxpayer problems.

IRS COMMENTS — PROCESSING ITIN APPLICATIONS

In 2003, the IRS completed an extended assessment of the ITIN program, including the possible dangers that can arise from the misuse of ITINs for the purpose of creating an identity and the associated possible threat to national security. We decided to make fundamental improvements to the program, including the two-step process, and believe these enhancements represent an appropriate balance to resolve ITIN program deficiencies without unduly burdening either taxpayers or the tax system. The two-step process ensures that ITINs are assigned only to taxpayers that have a legitimate need for tax purposes.

In FY 2004, the Service successfully processed approximately 1.3 million Form W-7 applications and over 900,000 related individual tax returns. Although a percentage of the applications and/or returns were not processed within our target goals, the process did meet the timeframes provided to the taxpayer. The 588 TAS cases represent .0005 percent of the 1.3 million applications. As acknowledged in the report, the average Form W-7 processing time for cases referred to TAS has improved from 90 days to 39 days, which includes corresponding for additional information and documentation on many cases. This demonstrates the effectiveness of the overall commitment of the IRS and the resulting improvements in efficiently processing the applications.

We acknowledge that, unfortunately, inconsistent information may sometimes be provided to taxpayers. However, we have made every effort to ensure the most current procedures are available to our Taxpayer Assistance Centers (TACs). ITIN procedures for TAC employees are outlined in IRM 21.3.4.20. When specific instances of non-conformance are observed, Field Assistance Headquarters contacts the appropriate Field Assistance Area Director for corrective action. When general non-conformance issues are identified, an alert is issued to remind TAC employees of correct ITIN procedures.

The IRS continually strives to achieve the highest quality standards that can be reasonably obtained. We acknowledge that, on rare occasions, such as when “family packs” of Forms W-7 and their respective tax returns are received, or when correspondence for missing information through the rejection process is necessary, a refund may be delayed.

The report also makes a comparison between the “two-step” process of a Form W-7 being processed prior to processing the tax return and the one-step process of just tax return processing. This comparison is not valid as the two-step process is necessary to verify a legitimate tax need for an ITIN and ensure more accurate and efficient processing of the tax return, which in turn, reduces burden to the taxpayer.

With respect to processing of Form 4868, Application for Automatic Extension of Time to File, the report states that there are no plans to change the current procedures. On the contrary, the business unit has been in constant contact with the TAS organization and has specifically stated that we are continuing to look at this process. In fact, new processing guidelines are currently being formulated for January 2005 implementation.

While we acknowledge situations may exist such as those detailed in the "Miscellaneous Problems with ITIN Processing," the circumstances that created those situations are, for the most part, cases of taxpayer or IRS employee error. No statistical information was provided to support that there are flaws in the processing instructions. The reference to ITIN notices issued in the wrong language is such an example. The form filed by the taxpayer, Form W-7 (English) or Form W-7(SP) (Spanish) determines the language used in a notice.

As mentioned earlier, there were a number of necessary changes made this year to ITIN processing. In an effort to capture improvement opportunities and refine the process, the Philadelphia Service Center hosted a critique session during the summer which included representatives from their ITIN Operations, TAS, Chief Counsel and Headquarters. Many of the issues outlined in the TAS report were identified as a result of that session and are being aggressively addressed.

IRS COMMENTS – AMENDED RETURN PROCESSING

Amended return processing problems noted in the TAS report reflect the necessary balance of timely processing and revenue protection. The population of cases focused on in this report constituted only one half of one percent of the amended returns processed. (Note: The statistics used in the problem statement provided by TAS are from different time periods; total amended returns processed for calendar year 2002, compared to TAS cases received in fiscal year 2003.) While delays are experienced in some areas, many times they are necessary in order to protect the revenue collected and ensure taxpayer compliance.

For several years, the IRS has diligently worked to improve the timeliness of amended return processing. We have made significant progress in improving the processing times and continue to implement innovative concepts to achieve additional improvements. For example, in the past year, a new method, the Correspondence Imaging System (CIS) began roll out to the Campuses. The system provides capabilities to route amended returns systemically between campuses. CIS also has the capability of retrieving a copy of the amended return from archive, thereby eliminating the possibility of returns being lost. The routing capability also improves the time it takes to review and process each case.

The IRS appreciates TAS' acknowledgment of Submission Processing's success in providing expeditious processing of non-technical amended returns. We do not agree, however, that the process increases the probability of a lost or misplaced amended return. This statement is supported only by the fact that no acknowledgement letter of receipt is sent to the taxpayer. These non-technical amended returns are processed in a short time period. To send an acknowledgement letter would only delay processing and would possibly be received at the same time or after the return is processed.

The IRS acknowledges that there are isolated instances when cases are delayed due to being lost or misplaced, or during peak periods, regardless of the processing area. We do not dispute that 69 percent of the amended return cases referred to TAS involve taxpayers experiencing a delay of 30 days or more in the processing of the return.

We recognize there are certain inherent delays in processing amended returns referred to Examination. However, reviewing these claims is a necessary step in maintaining the integrity of the tax system and encouraging voluntary compliance. In addition, Examination has guidelines and procedures to follow on TAS cases to expedite the review when refunds are delayed for an unreasonable time.

Improvements have been and continue to be made in the examination cycle time on EITC amended returns. Cycle times in this area have been reduced by 36 days, from 185 in FY 2003, to 149 in FY 2004. Much of the examination cycle time is attributable to the time taxpayers need to respond and submit all necessary documentation for resolution. The IRS also has a program goal of decreasing erroneous payments by identifying the potentially false EITC claims through risk-based scoring of Forms 1040X prior to posting of the adjustment.

In FY 2005, the IRS will launch a new command code for EITC that will capture amended return data and enable systemic filtering and Dependent Database scoring of amended returns to identify the returns with the highest potential for false EITC claims. The refunds for taxpayers not selected for examination by the new command will be immediately processed in Accounts Management without being forwarded to Examination for review. This will speed up refunds to many taxpayers, and help reduce cycle time on those returns examined. Once this command code is fully functioning in FY 2006, the volume of EITC amended returns sent to Examination should be reduced, thereby decreasing the age of the total amended return inventory. Since refunds will be paid faster, this should also reduce the amount of interest paid out by the IRS.

The IRS is also committed to reducing the impact on non-EITC amended returns that are sent to Examination based on specified criteria. To achieve this, the IRS has established a cross-functional and cross-divisional team to identify the patterns and characteristics of the amended returns being filed. The ultimate goal is to develop a risk-based scoring model for non-EITC examination-criteria amended returns. Currently, the IRS is updating amended returns training for Examination classifiers to assist with the classification of amended returns.

We do not agree that the payment of interest on refunds received as a result of claims allowed is a major problem. When an overpayment results from an amended return and the refund is issued within 45 days of the received date of the processible amended return, no interest is allowed from the received date of the amended return to the refund schedule date. Credit interest is, however, allowed from the credit availability date to the received date of the processible amended return. Based on examination data, the refunds requested on the majority of amended returns examined are not allowed. For FY 2003 and FY 2004, we closed approximately 59,000 and 54,000 individual amended returns resulting in revenue being protected in the amount of $355,000,000 and $423,000,000, respectively.

While we agree with the referenced Treasury Inspector General for Tax Administration's (TIGTA's) report that the IRS paid $3.5 billion in interest during FY 1999, the TAS report omits some critical elements. It should be noted that $2.2 billion of the interest can be directly related to the examination of 38 corporate taxpayers and did not involve amended return processing. The TIGTA report is also clear in stating "the amount of interest, if any, paid to a taxpayer is determined by a number of factors that have little to do with when the IRS became aware of an overpayment or how quickly it acted to return the money to the taxpayer." The TIGTA report recommended legislative changes to the laws governing interest and did not cite amended return processing procedures as a significant issue.

The IRS is committed to providing first class service to all taxpayers regardless of the circumstances. We do not believe that the one court case cited is representative of the IRS attitude towards internal delays and mistakes in amended return processing.

Accounts Management, Submission Processing and Compliance are working together to develop better process flows. Through the EITC re-engineering effort, the efforts of Accounts Management process improvement teams, such as Adjustment Customer Experience Improvement Team (ACE IT), additional pre-screening recommendations and alterations to the routing path for amended returns, improvements are being implemented.

IRS will continue to explore new methods and techniques, investing the appropriate time and resources, to improve processing times for tax returns, documents, and correspondence. We are committed to continual improvement of all our internal processes which will enable us to provide the best possible service to the taxpaying public.

TAXPAYER ADVOCATE SERVICE COMMENTS

The ITIN application two-step process was a serious problem for taxpayers over the past year.[57] *The IRS indicates in its response that comparing processing results under the two-step ITIN application process against processing results under prior procedures is invalid because the two-step process is needed to ensure that taxpayers have a legitimate tax need for an ITIN. The IRS' goal of having procedures designed to assign ITINs to taxpayers that have a valid tax need is reasonable and justifiable. This goal, however, does not preclude the IRS from measuring the impact these changes have had on customer satisfaction, employee satisfaction, and business results by comparing current results to levels under previous procedures.*[58] *Moreover, procedural change, even when justified by a compelling reason, can be better achieved when coupled with research and planning for the downstream consequences of that change to tax administration procedures.*

We outlined a number of negative consequences that resulted from the two-step process, and these consequences do not appear to have been contemplated prior to implementation of the new process. The IRS is now reacting to those negative consequences. Because these consequences were not anticipated, the IRS does not have useful information to fully measure the consequences of the two-step process, and therefore, it cannot measure the true utility of the two-step process. For example,

- *We know that 22 percent of ITIN applications were rejected at least in part due to the fact that taxpayers were not informed of or did not understand the requirement that tax returns must accompany ITIN applications, but the IRS does not know and did not measure how many of those rejected applicants reapplied for ITINs;*[59] *and*
- *We know that ITIN applicants submitting tax return extension requests on Form 4868 and following IRS instructions on Publication 1915 had their submissions destroyed, but the IRS does not know how many of those ITIN applications were destroyed, how many ITIN applicants reapplied for ITINs, or how many ITIN applicants received late filing penalties because of the destruction of the extension request.*

When the IRS makes a greater effort to measure the downstream consequences of its actions, it will implement better procedures and taxpayers will have fewer negative interactions with the IRS.

The IRS took exception to our representation that it had no plans to change the process which resulted in the destruction of taxpayer Form 4868 submissions. In fact, the IRS is now planning to change this process. On November 17, 2004, the National Taxpayer Advocate issued a Memorandum Precedent to a Taxpayer Advocate Directive (TAD) to correct the destruction of these submissions.[60]

[57] In its response, the IRS confused the sample size of TAS ITIN cases which were reviewed by TAS analysts with the actual population of TAS ITIN cases. The sample size was 588 but the actual number of TAS ITIN cases was over 4 times that many, 2,658 cases. The number of TAS cases is only one factor TAS considers in deciding that a particular issue is a most serious problem for taxpayers.

[58] The balanced measures system was adopted as part of the IRS reorganization effort and utilizes 3 criteria to assist it in determining procedure: customer satisfaction, business results and employee satisfaction. IRM 1.5.1.5.

[59] Calendar Year 2004 ITIN Processing Data Report through Sept. 24, 2004.

[60] The National Taxpayer Advocate has the non-delegable authority to issue a Taxpayer Advocate Directive to mandate administrative or procedural changes to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers). Taxpayer Advocate Directives are used when implementation

The purpose of the proposal memorandum is to ensure that a dialogue takes places between TAS and the IRS prior to the issuance of a TAD.[61] *The IRS promptly responded to proposal memorandum by agreeing to revise these procedures so that automatic extension requests on Form 4868 will now be treated in the same manner as discretionary extension requests on Form 2688. We applaud the IRS for taking this step.*

The IRS has been inclusive of TAS in its analysis of ITIN processing issues. The National Taxpayer Advocate appreciates the dialogue that has taken place between the IRS' ITIN processing unit and TAS and believes that the exchange of information has been beneficial to taxpayers and to the IRS.

Amended Return Processing

As described above, both the number and nature of TAS cases relating to amended return processing suggest that there may be a systemic problem in the processing of those returns. The IRS suggests that processing problems may be alleviated or eliminated by enhanced technology such as the Correspondence Imaging System. This technology is an important development, and the IRS should be praised for adopting it. While technology is important to reducing some errors or delays, it is vital that the IRS works towards a system which at a minimum codes all amended returns at the point of receipt and codes those returns as they travel through each process so that a taxpayer can find out where his or her return has been or is in the processing system. TAS does not suggest that all non-technical amended returns need to be acknowledged. However, at a minimum, the IRS should notify all taxpayers whose amended returns are to be subject to further review.

The IRS should be praised on its efforts to speed up EITC refunds to taxpayers. The establishment of a code that will allow the IRS to capture and subject to further review only those cases falling within the highest risk categories for false claims is a very positive development.

In light of the high numbers of TAS cases related to amended return processing, we have attempted to identify other measurements of amended return processing that the IRS can use to gauge the performance of the amended return processing unit. We indicated that one such measurement can be the amount of interest paid on refunds from amended returns. In preparation of this report, TAS sought to obtain information on the interest paid on amended return refunds but was told by the IRS that this information is not tracked. Because the IRS did not know how much interest it was paying on amended return refunds, we used information from the Treasury Inspector General for Tax Administration Report (TIGTA) which concluded that $3.5 billion in interest from amended returns and examinations had been paid for fiscal year 1999.[62] *In its response, the IRS objected to the citation of this report indicating that $2.2 billion of this $3.5 billion was related to the examination of 38 corporate taxpayers. It is important to point out, however, that $1.3 billion paid on amended*

will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers. Only the National Taxpayer Advocate or the IRS Commissioner or Deputy Commissioner can modify, rescind or revoke a TAD. IRM 13.1.4.2.2.5.

[61] IRM 13.2.1.5.1.2.

[62] Treasury Inspector General for Tax Administration (TIGTA), *Tax Law Changes Are Needed to Improve Fairness in Paying Interest on Tax Refunds*, Reference No. 2001-30-148, 7 (Sept. 2001).

return refunds and exams to over 4.8 million individual and business taxpayers is not insubstantial.[63] *We repeat our recommendation that the IRS track interest paid on amended return refunds as way of gauging the success of that processing unit.*

Like the IRS, the National Taxpayer Advocate hopes that the case ***Palihnich v. Commissioner*** *is not representative of attitudes within the IRS about the IRS' own processing errors. However, positions reflected in court pleadings are not taken casually and often reflect the input of the client. The fact that this case was actually litigated is indicative of a failure of customer service in more than one function of the IRS. The IRS would enhance its credibility with taxpayers and their representatives by settling or even conceding issues where its own errors play a substantial role in the dispute.*

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations to improve the processing issues raised in this report:

With respect to the ITIN application process, the IRS should:

- *Allow and encourage applicants to file an ITIN application without a return prior to the filing season if documentation can be submitted with the application that a return will be required to be filed, e.g., proof of income (wages), withholding, or prior filing of return and ITIN needed for spouse or dependent;*
- *Ensure that Publication 1915 (Understanding Your IRS Individual Taxpayer Identification Number) provides accurate instructions to conform with the actual handling of ITIN applications;*
- *Revise the ITIN application rejection notice to enclose IRS Publication 4134 (Low Income Taxpayer Clinic List), so that ITIN applicants are aware of a readily available resource to assist them;*
- *Ensure all TAC employees are trained in the procedures for reviewing and validating applications prior to forwarding to the ITIN processing unit.*
- *Establish procedures, including quality review, to ensure that "family packs" are not separated when received by the IRS or during the processing of the ITIN applications;*
- *Revise the ITIN Database to generate a copy of the notice issued to an applicant to the Acceptance Agent or Power of Attorneys who submitted the application.*

With respect to amended return processing, the IRS should:

- *Conduct Customer Satisfaction Surveys on amended returns;*
- *Code and track the receipt of all amended returns;*
- *Acknowledge receipt of all amended returns that are forwarded from Submission Processing to another function for further review;*
- *Collect data on the amount of interest paid on amended return refunds as a diagnostic measure.*

[63] *Id.*

PROBLEM

TOPIC C-11 MOST SERIOUS PROBLEM: LACK OF NOTICE CLARITY

RESPONSIBLE OFFICIALS

Henry O. Lamar, Jr., Commissioner, Wage & Investment Division
Kevin M. Brown, Commissioner, Small Business/Self-Employed Division
Deborah M. Nolan, Commissioner, Large and Mid-Size Business Division,
Steven T. Miller, Commissioner, Tax Exempt and Government Entities Division

DEFINITION OF PROBLEM

The IRS sends out more than 100 million notices to taxpayers each year.[1] Because these notices relate to the substantial amount of taxes paid to the Department of Treasury, taxpayers have a right to expect them to be concise, clear and correct. In an era when technology facilitates direct marketing of specific account information to customers, taxpayers expect some degree of sophistication from the Internal Revenue Service (IRS). However, these expectations have not been met. Unclear notices are still one of the main reasons why taxpayers write the IRS.[2] As a recent notice study commissioned by IRS concluded:

> Communicating with taxpayers costs money. Unfortunately, it too often costs double because either the taxpayer doesn't understand the meaning of the notice well enough to comply accurately with the IRS' request or the taxpayer is so confused that he calls the IRS for clarification of the notice information.[3]

The continued failure to communicate effectively through notices, which impact more taxpayers than any other IRS methodology, causes undue taxpayer burden, IRS re-work, and frustration with the tax system.

For decades, the IRS has agreed with internal and external findings that the quality of its notices to taxpayers needs to be improved for tone, clarity of message, accuracy, and effectiveness of communicating the right message at the right time to result in the desired action by the recipient. The IRS has allocated significant resources towards notice redesign, and more recent examinations of redesign efforts have drawn praise.[4]

However, the complex environment facing taxpayers today, coupled with changes in the tax laws, has outpaced the efforts of the IRS to redesign its more than 400 different

1 Treasury Inspector General for Tax Administration (TIGTA), I*ncreased Attention is Needed to Ensure the Success of Future Notice Redesign Efforts*, Reference No. 2002-30-040, 1 (Dec. 2001).

2 IRS, *IRS Budget in Brief*, Fiscal Year 2003, Document 9940, 4 (Rev. 1-2002).

3 Kleimann Communication Group, *Voice of the American Taxpayer*, 19 (June 28, 2002).

4 Tax Inspector General for Tax Administration, *The Clarity and Accuracy of Taxpayer Notices Are Actively Being Improved*, Reference No. 2004-40-099 (concluding that in general the IRS has established a framework for implementing an effective notice process that assesses all taxpayer communications for clarity, completeness and accuracy) (May 2004).

notices. Specific examples of poorly structured notices provided below raise questions about the IRS notice redesign efforts, including: *Is the IRS properly identifying poorly drafted notices? Is the IRS providing the taxpayer the necessary information to make its notices clear? Does the IRS redesign process move quickly enough? Has the IRS been given the proper incentives to correct broadly worded and ambiguous notices?*

ANALYSIS OF PROBLEM

Background

While the quality of IRS notices has been the source of public frustration for many decades, the focus of modern criticism can be traced to 1988 when Congress enacted Internal Revenue Code § 7522, which mandated clarity in certain IRS notices.[5] Although IRC § 7522 applies only to limited categories of notices, Congress expressed its desire that the IRS improve all notices:

> Although the provision is limited to the specified notices, the conferees expect the IRS to make every effort to improve the clarity of all notices and explanations that are sent to taxpayers. *The conferees believe that all correspondence should be sufficiently clear to enable a taxpayer to understand an IRS question about a tax return as well as any adjustments or penalties applied to a tax return.*[6] [emphasis added]

The IRS began to focus on the problem of notice clarity amidst the growing internal and external criticism leveled at the quality of its notices.[7] In response to these criticisms, over the past decade the IRS has devoted substantial personnel and resources to its notice problem, including:

- Establishing a Notice Modernization Team in November 2000 to assess the end-to-end notice process and identify major improvement opportunities;[8]

[5] IRC § 7522 (entitled "Content of tax due, deficiency, and other notices") provides as follows:
(a) General rule–Any notice to which this section applies shall describe the basis for, and identify the amounts (if any) of, the tax due, interest, additional amounts, additions to the tax, and assessable penalties included in such notice. An inadequate description under the preceding sentence shall not invalidate such notice.
(b) Notices to which section applies.–This section shall apply to–
(1) any tax due notice or deficiency notice described in section 6155, 6212 or 6303,
(2) any notice generated out of any information return matching program, and
(3) the 1st letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the Internal Revenue Service Office of Appeals.

[6] H. Conf. Rept. 100-1104, at 219 (1988).

[7] In 1988, the IRS Commissioner's Advisory Group reported that approximately one-half of the correspondence received by taxpayers and practitioners was wrong or incomplete. *IRS Displeased With Tax Adjustment Notice System*, 41 Tax'n for Acct. 350 (Nov. 1988).

[8] Tax Inspector General for Tax Administration, *Increased Management Attention Is Needed to Ensure the Success of Future Redesign Efforts*, Reference No. 2002-30-040, 2 (Dec. 14, 2001).

- Establishing a Single Point Of Contact (SPOC) for notice issues within each IRS operating division and function;[9]
- Establishing a Notice Communication Advisory Group comprised of the SPOCs and Chief, Notice Support that assists in identifying and establishing notice initiatives, and reviewing and addressing notices that pertain to more than one operating division;
- Establishing a Notice Support Group to provide service-wide support to the operating divisions and SPOCs;
- Establishing various Notice Process Improvement Initiative Teams (NPIITs), including the Notice Elimination NPIIT,[10] the Taxpayer Notice Code NPIIT,[11] and the Notice Standardization NPIIT[12] to provide support and input to the notice modernization effort;
- Establishing Dynamic Project Teams (DPTs), which take on notice redesign initiatives passed along by the Notice Communication Advisory Group (NCAG) and/or OD SPOC;
- Establishing an Office of the Notice Gatekeeper, which researches, analyzes and evaluates all taxpayer correspondence for potential impact on enterprise resources and confirms the accuracy and appropriateness of the toll-free numbers listed on communications;[13] and
- Spending in excess of three million dollars on notice initiatives, notice consultants, studies, and surveys in the last two years alone.[14]

In the light of this formidable notice bureaucracy that has now taken hold within the IRS, the question remains whether the IRS has met the straightforward standard put forth by Congress in 1988. In other words: *Are IRS notices sufficiently clear to enable a taxpayer to understand an IRS question about a tax return as well as any adjustments or penalties applied to a tax return?* While select notices have improved, for too many IRS notices the answer to this question is still "no."

[9] In 1998, the IRS was reorganized into four operating divisions (Wage and Investment (W&I), Small Business/Self-Employed (SB/SE), Large and Mid-Size Business (LMSB), and Tax Exempt and Governmental Entities (TE/GE)), two support divisions (Agency-Wide Shared Services (AWSS) and Modernization, Information Technology and Security (MITS)) and five functional business units (Appeals (AP), Chief Counsel (CC), Criminal Investigation (CI), Communications and Liaison (C&L), and Taxpayer Advocate Service (TAS)). Each function has designated a Single Point of Contact (SPOC) to address notice issues related to that function and each function is responsible for the notices it sends to its taxpayers.

[10] The purpose of the Notice Elimination NPIIT is to identify "obsolete or redundant" notices messages, merge notices with similar messages, and identify alternate delivery channels to deliver notice messages.

[11] The objective of the Taxpayer Notice Code NPIIT was to refine and revise the codes used to determine the message inserted into notice templates and to advise taxpayers more specifically of errors made on returns.

[12] The Notice Standardization NPIIT was established to develop standards for all IRS notices so that they have a similar look and feel and use consistent language in communicating with customers.

[13] IRS, Office of Notice Gatekeeper.

[14] IRS Notice Support Group, Notice Improvement Contracts for 2003 and 2004.

IRS Notice Systems and the Redesign Process

The IRS generally issues notices by using one of several systems of pre-established templates and inserting taxpayer-specific information. This information is determined by a manual or computer analysis of tax return and payment data. The IRS sends most of its notices from a "computer paragraph" (CP) system, which identifies the appropriate notice from over 300 possibilities based on the analysis performed. Another system known as Correspondex contains over 300 pre-established subject matter templates. This system offers employees a selection of notices per topic, and within each notice a selection of paragraphs from which the employee selects the relevant ones. These systems do not provide the flexibility to tailor notices to particular taxpayers, nor is there any established process to adapt notices to specific taxpayers beyond what the templates have to offer.

The redesign process established by the IRS is a collaborative effort among the four operating divisions and various notice groups and committees. However, the four operating division commissioners are ultimately responsible for the quality of their respective notices.[15] A Single Point of Contact (SPOC) within their respective organizations and a Notice Support Group (NSG), which provides Servicewide key services for notice improvement efforts, support the commissioners and functions. The SPOCs and the Chief of NSG also serve on a Notice Communication Advisory (NCAG) that provides for cross-functional decision-making and information sharing.

The SPOCs coordinate and drive notice activities within each operating division, such as creating and modifying notices and putting measures in place to assess notice effectiveness. When notices are identified for revision, one or more SPOCs may charter a Dynamic Project Team (DPT) to modify the content of one or more notice(s). The DPT assumes responsibility for the notice redesign process, which includes determining what substantive changes are needed, soliciting input from key internal and external stakeholders, and taking the necessary bureaucratic steps to request a change to IRS computer systems and the support of the information technology organization. The process is designed to take 17 months from beginning to end but can last substantially longer depending on the variables of each particular notice. The IRS acknowledges that this delay dissuades some employees from championing notice changes.

Problematic notices fall into many categories. However, this year the National Taxpayer Advocate is focusing on two categories: (1) notices that on their face are so confusing they would leave any rational taxpayer uncertain of why the notice was sent or how to respond, and (2) notices which omit vital information that may impact a taxpayer's decision to take necessary actions, such as appealing the IRS' proposed action.

[15] Treasury Inspector General for Tax Administration, *The Clarity and Accuracy of Taxpayer Notices Are Actively Being Improved*, Reference No. 2004-40-099, 1 (May 18, 2004).

Confusing Notices

Some notices that inform taxpayers of problems with a return do not explain the specific problem that led to the notice. Instead, they give a variety of possibilities that leave the taxpayer to wonder what change or action is required. For example, the IRS uses notice CP 207 to notify businesses of its intent to impose a penalty for a taxpayer's alleged failure to deposit payroll related taxes.[16] The opening paragraph provides, in part, as follows:

> WE CAN'T DETERMINE IF YOU MADE YOUR FEDERAL TAX DEPOSITS ON TIME AND IN SUFFICIENT AMOUNTS ON YOUR FORM 94x FOR TAX PERIOD ENDING DECMEBER 31, ____. THE RECORD OF FEDERAL TAX LIABILITY (ROFT) SECTION ON YOUR FORM WAS EITHER MISSING, INCOMPLETE, UNREADABLE, OR THE TOTAL LIABILITY ON THE RECORD OF FEDERAL TAX LIABILITY (ROFT) DIDN'T EQUAL THE TAXES SHOWN ON THE FORM.

The notice later continues:

> IF WE DON'T HEAR FROM YOU BY _____________, WE'LL FIGURE A PENALTY AND SEND YOU A BILL USING THE INFORMATION AVAILABLE TO US.

A rational taxpayer could come to the conclusion that the IRS is sending this notice because it does not know whether the taxpayer complied with the deposit requirements, but is nonetheless intent on assessing a failure to deposit penalty unless the taxpayer can prove otherwise. This notice is a very confusing communication because it gives a number of conflicting reasons as to why the letter is being sent, does not inform the taxpayer of what to do or how to cure the defect, and threatens the taxpayer with a penalty for failure to act even though the taxpayer does not know what he or she is required to do. This clearly fails the standard set down by Congress in 1988 because the notice does not say exactly why the taxpayer is receiving the notice and what specific action or lack of action by the taxpayer is being addressed. Unfortunately, multiple examples of this type of notice are in use.[17] This creates an additional burden to tax compliance. At a minimum, each notice should be specific as to

---

[16] IRC § 6656 provides for the assessment of a penalty for the failure to deposit certain taxes, including income taxes withheld from wages and taxes under the Federal Insurance Contributions Act (FICA).

[17] Another example of this style notice is the one used to notify taxpayers of a mismatch of income reflected on a taxpayer's return with certain information returns (IRS Notice CP 240). This notice also provides a variety of possibilities giving rise to the notice, as follows:

> WE MADE THIS ADJUSTMENT BECAUSE THE AMOUNTS SHOWN ON YOUR INFORMATION RETURNS (FORM W-2, WAGE AND TAX STATEMENT; FORMS 1099-R DISTRIBUTIONS FROM PENSIONS, ANNUITIES, RETIREMENT OR PROFIT SHARING PLANS, IRA, INSURANCE CONTRACTS; OR FORM W-2G, STATEMENT FOR CERTAIN GAMBLING WINNINGS) DIDN'T MATCH THE FIGURES SHOWN ON YOUR EMPLOYMENT TAX RETURN(S) FOR THE TAX PERIOD SHOWN ABOVE. THIS WAS EXPLAINED IN A LETTER WE SENT YOU EARLIER.

Again, this notice places the burden on the taxpayer to ferret out the specific alleged error to which the IRS is alluding and to which the taxpayer must respond.

what information is needed so taxpayers can review their records to determine whether they agree or disagree with IRS' findings, without further contact with the IRS.

It is worth noting here that the National Taxpayer Advocate has identified problems with Federal Tax Deposit (FTD) penalties, including erroneous assessments, as a serious problem affecting business taxpayers.[18] FTD penalties are often abated because of erroneous assessments.[19] A system that suffers a high error rate in the assessment of penalties, coupled with a notice system which places the burden on the taxpayer to figure out why a penalty has been assessed, results in ineffective and inefficient tax administration. The notice should state exactly why the IRS is proposing to assess the penalty and not shift the burden onto the taxpayer of ferreting out the reason.

As indicated above, the modern IRS notice redesign process utilizes SPOCs, NPIITs, the NCAG and DPTs to redesign confusing notices. This redesign process relies in part on training material provided by outside vendors which provides ways to think about notices and their structure. Much of the redesign training material emphasizes visual techniques that will make the notice easier to read, such as the use of bold fonts, subheadings and simple non-technical terms.

While notices that have been subject to redesign are often more readable than their predecessors, they still can be confusing. The redesigned notice that informs taxpayers of either a balance due or an overpayment (CP21C) now reads as follows:

We Changed Your Account

We will explain why you received this notice, how we changed your account, how this change affects you, and actions you may wish to take.

Why You Received This Notice

We changed your 2002 account to correct your account information.

How We Changed Your Account

We changed your account as follows:

Account balance before this change	$________
Increase in tax because of this change	$________
Interest charged	$________
Amount you now owe	None

[18] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003) 200.

[19] Approximately 23 percent of the failure to deposit penalties assessed under this system are later abated, including abatements for reasonable cause. IRS Data Book 2002, Table 26, 33.

The redesigned CP21C may be easier to read in its use of bold fonts, subheadings and non-technical language, but again it fails to accomplish the most important task of all: telling the taxpayer *why* the account was changed. It is important to reiterate that Congress' primary concern in 1988 was that taxpayers should understand the *why* of IRS notices.[20] An IRS sponsored study confirms that the most important questions a taxpayer has about a notice are: (i) *why am I receiving this notice?* and (ii) *what am I supposed to do?*[21] When taxpayers understand the *why* of a notice, they have a better chance of verifying what the IRS has done and will be more likely to comply with the notice.[22] A taxpayer receiving a CP21C will only be confused because it does not explain why the IRS took the action. Such confusion will inevitably lead to otherwise avoidable additional contacts between the taxpayer and the IRS.

Confusion from IRS communications can also result in taxpayers not taking advantage of their rights under the law. This was evident in a research study on taxpayers who were denied the earned income tax credit (EITC) and who sought audit reconsideration from the IRS Exam function.[23] This study sought to compare audit outcomes of those taxpayers who had TAS assistance and those who did not in hopes of identifying ways of improving the accuracy and effectiveness of the audit reconsideration process.[24] One part of the study concluded that two hundred sixty two taxpayers (42 percent of the sample) were denied the EITC because of late responses or no responses to IRS EITC notices.[25] However, approximately 43 percent of this group (113 out of 262 taxpayers) had favorable outcomes from the audit reconsideration process, which is about the same as the favorable outcome rate for all taxpayers in the sample.[26] The study demonstrates that when the IRS does not communicate clearly taxpayers may not understand their rights and, therefore, may inadvertently give up those rights.

Notices that Omit Vital Information

The notices described in this section are those which (while they also may be confusing) omit so much vital information as to be misleading.[27] Two examples of this problem are the letter sent to taxpayers when the IRS determines that different taxpayers filed returns using the same Social Security Number (Letter 239SC) and the letter to individuals whom

[20] H. Conf. Rept. 100-1104, at 219 (1988).

[21] Kleimann Communication Group, *Voice of the American Taxpayer* (June 28, 2002), 21.

[22] *Id.*

[23] Taxpayer Advocate Service Office of Systemic Advocacy, *Earned Income Tax Credit Audit Reconsideration Study*, 4 (December 2004). This study was conducted in conjunction with the IRS Office of Reporting Compliance Examination.

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] The CP21C, described earlier, also omitted the *why* portion of the notice, and therefore, it could also be considered a notice that omitted vital information. However, the notices in this section omit so much information as to be misleading, possibly causing a taxpayer not to exercise a meaningful right under the law.

the IRS believes are "responsible persons" under IRC § 6672 for failing to remit certain payroll taxes and withheld income taxes (Letter 1153).

Letter 239SC

Elsewhere in this report, the National Taxpayer Advocate identifies inconsistent IRS campus procedures for resolving stolen identities as a significant problem for taxpayers.[28] Five hundred thousand to seven hundred thousand people in the United States are victims of identity theft every year.[29] They must often endure the hardship of trying to restore their identities on the databases of creditors, credit reporting agencies, and federal, state and local governments. Employment is one motive for stealing Social Security numbers (SSNs), since the absence of a SSN is a barrier to working in this country.[30] When the IRS finds that more than one tax return has been filed utilizing the same social security number but cannot determine to whom that number rightfully belongs, it sends Letter 239SC, together with a form requesting five pieces of information, to all taxpayers utilizing the number.[31] The consequences of the taxpayer's response to this notice are dramatic because if the IRS cannot determine to whom the SSN belongs, it will utilize its "scrambled SSN" procedures whereby it denies use of the SSN on tax returns to all taxpayers and assigns them temporary numbers. The rightful owner can lose the tax use of his or her SSN for years as the IRS and Social Security Administration try to resolve the problem. If the taxpayer does not aggressively respond to Letter 239SC and provide as much back-up information as possible, the taxpayer could be denied tax use of his or her SSN.

Unfortunately, Letter 239SC provides none of this information and does not alert the taxpayer to the seriousness of the dilemma. Letter 239SC states:

> A return or document you filed with us shows the above social security number. The social security number is on our records for another taxpayer. We would appreciate your help in determining the correct name for this number.
>
> Please complete the enclosed Form SS-5 and section below, and return them to us. An envelope is provided for your convenience. The copy of this letter is for your records.
>
> Please let us hear from you as soon as possible. We will forward your Form SS-5 to the Social Security Administration. They will tell us your correct number and let you know what number to use in the future. You should

[28] *See* this report, Most Serious Problem, Inconsistent Campus Procedures, *supra*.

[29] Hearing Before the Senate Special Committee on Aging, *Identity Theft: The Nation's Fastest Growing Crime Wave Hits Seniors*, 107th Cong. 2nd Sess, (2002) (opening statement of Chairman John Breaux), at http://aging.senate.gov/events (hearing publication unavailable as of Oct. 2002).

[30] IRC § 6109(d).

[31] The information form asks for the taxpayer's name, any other names used by the taxpayer, Social Security Number (if different from the SSN provided to the IRS), whether the taxpayer filed an amended return and if so when the return was filed. IRS Letter 239SC.

continue to use the number shown on your card unless you are notified to use a different one.

TAS case advocates work many stolen identity cases where tax examiners on the campuses scramble the SSN of the rightful owner, although information to validate the use of the SSN may be readily available from IRS sources such as Integrated Data Retrieval System (IDRS).[32] Taxpayers need to be told what will happen if the IRS cannot determine the correct SSN owner. With this information, taxpayers will be more vigilant in helping the IRS to substantiate their valid use of SSNs. The IRS creates problems for itself and the taxpayer by not providing complete information in notices.

Letter 1153

TAS has also received many cases involving officers of businesses who have been assessed personal liability under IRC § 6672 for the trust fund portion of payroll taxes and income tax withholding that was never remitted to the IRS.[33] Often, these individuals do not understand the basis of the action, because this area of the law is confusing to both taxpayers and practitioners. In general, IRC § 6672 imposes personal liability on employees and officers of a business who fail to collect, truthfully account for, and pay over withholding taxes to the IRS.[34]

In a typical situation, a struggling business that has fallen behind in its bills pays other creditors before the IRS to assure a continued supply of needed goods and services. The responsible individuals may hope that by the time the IRS inquires about the tax, the business will have turned around and be able to satisfy the liability.[35] The analysis into personal responsibility is heavily fact intensive, and unlike other areas of tax law is dependent on how the enterprise was run on a day-to-day basis. No one factor is definitive, but the primary factors in determining responsibility are the control of funds; authority to sign or co-sign checks; actual instances of signing checks; authority to determine which creditors to pay; status as officer, director or shareholder; management of the day-to-day business; authority to hire and fire; and authority to borrow money.[36] In other words, there are many defenses to the IRC § 6672 penalty.[37]

---

[32] In June of 2004, TAS began tracking stolen identify cases on the Taxpayer Advocate Management and Information System (TAMIS) with a Primary Core Issue Code of 425 and reflects 346 stolen identity cases for FY 2003 from June of 2004 to October 1, 2004.

[33] FY 2004 Taxpayer Advocate Management Information System (TAMIS) receipts reflect 730 Trust Fund Penalty Recovery Cases (Primary Core Issue Code 550).

[34] IRC § 6672.

[35] CCH Standard and Federal Tax Reporter, ¶39780, p. 64,430 (2004).

[36] *Harris v. U.S.*, 175 F.3d 1318, 1321 (11th Cir. 1999) (holding that jury could find corporate officer with check signing authority and the power to decide on corporate disbursements as being a responsible person); *see also* CCH Standard and Federal Tax Reporter, ¶39780, p. 64,431 (2004).

[37] Harry Charles, *Winning the Trust Fund Recovery Penalty Case in IRS Appeals*, 14 No. 2 Prac. Tax Law 19 (2000); Jerome Borison and Steven R. Anderson, *When the IRS Wants Your Client to Pay Trust Fund Taxes*, 26 Colo. Law. 105 (1997).

Despite the fact that trust fund cases are heavily fact intensive depending on the authority of the employee, Letter 1153, which the IRS sends to the employees and officers to assess personal responsibility, provides no detail about the actual powers and control which the IRS alleges the individual possessed, nor any of the findings of the revenue officer conducting the investigation. Taxpayers assessed this penalty often tell TAS case advocates they did not understand the implications of Letter 1153 and therefore did not make use of appeal procedures.[38] Again, Letter 1153 does not explain the *why* of the situation. The letter is doubly deficient because it does not tell why the IRS is proposing the penalty nor does it tell why it is important for the taxpayer to respond and request an appeal that may be their only opportunity for a pre-payment review.

The IRS Should Explain "Why" and "What Next"

In spite of its substantial notice redesign efforts, the IRS has not revised some of its most confusing notices, which often fail to explain the basis for the IRS' action or advise the taxpayer of his or her required "next steps." However, the IRS has demonstrated that it can effectively provide taxpayers this type of information when it involves taxpayers and other external stakeholders in the notice redesign process. The most recent EITC certification notices are examples of notices that effectively explain what the next steps are for taxpayer.[39] These notices have been carefully designed with subheadings such as *"Why We're Sending You This Letter," "What You Need to Do,"* and *"Follow these Steps,"* followed by simple and concise explanations of what is expected of the taxpayer.[40]

Too often, when the IRS does redesign a notice, it is more readable but provides little additional information. One possible cause for this failure is that the notice redesign effort has simply not focused sufficiently on providing the *why* to the taxpayer or what steps the taxpayer should take in responding to the notice. Explaining *why* and "next steps" to taxpayers involves more than just redesigning the way notices look. It involves a commitment to improve IRS notice systems so that notices provide taxpayers detailed information about their accounts.

One possible solution to the notice dilemma may lie in the example of the Notice of Deficiency, Letter 531. As described above, IRC § 7522 was enacted because of the poor quality of these notices and requires that they maintain a certain level of clarity. While

[38] Failing to respond to Letter 1153 waives all appeal rights on the personal responsibility determination, including the right to argue this issue in a subsequent collection due process hearing. *Pelliccio v. U.S.*, 253 F.Supp.2d 258 (D. Conn. 2003).

[39] A cross-functional team comprised of various interests inside and outside the IRS worked to design and redesign EITC certification notices. Within the IRS, these participants included W&I Field Compliance, Computer Assisted Review of Error Resolution System (CARE), IRS Forms and Publications personnel, SPOCs, EITC specialists and TAS. Externally, the certification forms were vetted extensively with external stakeholder groups at various stages to ensure external partners had ongoing involvement in modifying the process. Additionally, the IRS sought public comment during the design process. See IRS First Early Certification Notices (CP84A) and IRS Final Reminder (CP84D).

[40] *See* IRS Early Certification Notices (CP84A) and IRS Final Reminder (CP84D).

the statute specifically provides that the notice will not become void simply because of a lack of clarity, courts have held that a lack of clarity can shift the burden of proof away from the taxpayer.[41] Many cases have been litigated over the quality of IRS notices.[42] The net result of IRC § 7522 and the subsequent redesign efforts has been that the modern Notice of Deficiency is a clearer document, which provides a detailed revenue agent's report with an explanation of specific items the IRS proposes to change. The Notice of Deficiency serves as one model for redesign efforts.[43] Unfortunately, it took an act of Congress to bring about these changes. Unless the IRS makes answering *why* a priority in all IRS notices, IRC § 7522 may need to be expanded to cover additional notices.

IRS COMMENTS

The Taxpayer Advocate Service recognized some of the progress made to date by the IRS to improve notices and letters sent to taxpayers. The Treasury Inspector General for Tax Administration recognized some of the same progress in its May 2004 report *The Clarity and Accuracy of Notices*. In July 2001, the IRS Commissioner's Tax Administration Council approved the new notice governance structure. Simplifying and improving the clarity of notices and other communications to taxpayers is one of the top priorities in the IRS. In addition to notice simplification efforts, the IRS has developed notice strategies that include:

- Training employees to write to taxpayers in plain language;
- Testing simplified notices to determine whether they will meet customers' needs before placing them in production,
- Measuring the effectiveness of simplified notices,
- Incorporating tax practitioner and taxpayer input into the notice change process,
- Standardizing notice language and layout, and
- Developing tools that support and facilitate the Dynamic Project teams.

In General

Since October 2000, the IRS has redesigned and placed into production approximately 45 notices that have a combined annual volume of more than 38 million. We have devel-

[41] *Shea v. Comm'r*, 112 T.C. 183 (1999) (holding that failure to specifically allege matters in notice of deficiency shifts burden to IRS).

[42] For example, see *Scar v. Comm'r*, 814 F.2d 1363 (9th Cir. 1987) (holding that IRS failed to prove that the IRS had determined a deficiency where notice of deficiency contained incorrect amounts of tax owed and referenced partnership to which taxpayers did not belong); *Shea v. Comm'r*, 112 T.C. 183 (1999) (holding that failure to specifically allege matters in notice of deficiency shifts burden to IRS); *Pietanza v. Comm'r*, 92 T.C. 729 (1989) (holding confusing and inconsistent statements by IRS to taxpayers overcame any presumption which might ordinarily operate in favor of the IRS); and *Rochelle v. Comm'r*, 116 T.C. 356 (2001) (holding notice of deficiency was valid even though it omitted due date for taxpayer's petition).

[43] As described above, another model could be the Notice 84 series used for the Earned Income Tax Credit (EITC) Recertification program.

oped a process for prioritizing the simplification of notices that are sent to individual taxpayers. This process applies weighted criteria linked to the IRS' three balanced measures to determine the order of priority. Two external stakeholder groups provided input to the IRS during the prioritization process. The IRS plans to continue this effort for notices sent to businesses.

The IRS also developed and issued the first customer satisfaction surveys to taxpayers who received one of 13 different notices. The IRS designed the survey to assist in determining the effectiveness of the redesigned taxpayer notices. More than 7,500 taxpayers responded to the survey – a 33 percent response rate. Results from the survey demonstrated that, for the most part, taxpayers could understand the notices and could take the appropriate action requested but also identified areas that need further improvement.

Examples of recent positive changes in notices include substantial revisions to the 13 math error and adjustment notices – combined annual volume 13 million - that inform taxpayers about changes the IRS made to their account. Another early effort included a redesign of the LT-11, Collection Due Process Notice – annual volume 1.2 million. In July 2004, the IRS started issuing the re-engineered CP 71 series notices – Reminder of Balance Due – annual volume 6 million. The TAS SPOC representative had identified these notices as problematic for taxpayers. A major design effort is also underway to significantly improve the CP 2000 notice - We're Proposing Changes to Your Tax Return – annual volume 2.3 million - issued to taxpayers who have under-reported income on their tax return. The revised notice is scheduled for production in December 2004. The revised CP 2000 represents a significant effort to improve dramatically the notice to enhance taxpayer understanding of why they received the notice. We conducted numerous tests, focus groups, and discussions with many tax professionals during the development process, and included many of the comments received in the final product.

The IRS has five more notices scheduled for February 2005 production, which will increase the annual volume of simplified notices to 44M – approximately 40 percent of the total volume issued in a calendar year. Two of these notices relate to eligibility for the Earned Income Tax Credit, a continuing problem area for taxpayers, and another focuses on educating taxpayers about potential eligibility for the Additional Child Tax Credit.

The TAS report describes the new process put into place to re-engineer notices. Under the new structure, teams of IRS employees with subject matter expertise form a Dynamic Project Team (DPT) to analyze the current notice, determine the requirements for the notice with all internal and external stakeholders, and then re-engineer the notice. Part of the training we give these teams stresses the importance of customizing the notice to an individual taxpayer's situation and providing a clear reason for the notice. Although our computer systems have certain limitations, we have been very successful in implementing most recommended changes.

A recent DPT effort is in the final stages of delivering five re-engineered collection notices, including the CP 504 – Intent to Levy Notice – annual volume 6.4 million. The IRS has also established two teams that have just started work on the collection installment agreement notices, and the Automated Substitute for Return program's statutory notice of deficiency – combined annual volume 22 million. The Taxpayer Advocacy Panel (TAP) area groups validated that the CP 521 Installment Agreement Reminder notice is one notice needing improvement and provided recommendations for improving the notice.

Other teams will review notices issued when the taxpayer makes estimated tax payments and the IRS finds a discrepancy in the amount paid by the taxpayer – annual volume 1.9 million.

The IRS welcomes any additional specific data-driven analysis and information the TAS organization can provide on problematic notices. As we plan our future simplification efforts we will consider the notices identified in the report and the information you provided about them. The TAS organization has a SPOC who has been part of the Notice Communication Advisory Group and can, in the future, assist the IRS in identifying notices that cause taxpayers problems.

Abating Federal Tax Deposit Penalties

The IRS does not agree with the information reported on page 167 of the TAS report that attributes the abatement of Federal Tax Deposit (FTD) penalties to IRS errors and unclear notices. We believe it is important to note that the IRS often abates penalties for reasonable cause, even when the taxpayer has not made the proper Federal Tax Deposits.

CP 21C – Adjustment Notices

The NTA identified that the CP 21C adjustment notices do not always contain sufficient information to explain the reason for the adjustment. Recently changes were made to the system that generates the reasons for the notices. This will allow IRS employees to select paragraphs for inclusion in the notice that will provide more specific reasons for the adjustment. From results of an IRS survey conducted on the CP 21C in 2003 and 2004, more than 94 percent of the taxpayers who completed a survey understood why the IRS sent the notice and made an adjustment to the account.

239C letter – Two or more taxpayers using the same SSN

A Dynamic Project Team will review and revise the entire 239C letter.

EITC Letters

The IRS is committed to improving correspondence examination notices, including those containing EITC issues. Examination issues, especially those involving EITC are among the most complex issues facing taxpayers. During FY 2004, a multi-functional Notice

Reengineering Team, with Taxpayer Advocate Service representation, redesigned the initial contact letter, Letter 566B-EZ. The NTA's 2003 Annual Report refers to this letter as the Combination Letter in Most Serious Problem, Topic #6. The team streamlined the current four-step process to provide taxpayers more information earlier in the process and an earlier opportunity to resolve the problem. The team created a new contact letter (CP75) that addresses the concerns raised by the NTA in 2003. New CP 75, and the streamlined process is a major step forward in effectively communicating the examination and appeal processes and the steps taxpayers must take to exercise their rights under the law. The new CP 75 includes the following:

- A main heading definitively notifying the taxpayer of examination
- Explanations that include **Why We're Reviewing Your Return ; What You Need to Do Now; What We'll Do Once We Hear from You; What Happens If You Don't Reply; and How to Get Help.**
- A table, "Follow These Steps," that summarizes what needs to be done.
- Direction to call the IRS toll-free number if the taxpayer cannot get the information within the 30 days.

Letter 1153

The TAS report equates the TAS inventory of IRC §6672 cases with failures in the Letter 1153. The discussion of Letter 1153 considers that letter in isolation when, in fact, it is only one letter in a process that requires interaction and investigation. During this investigation process, revenue officers explain the process and advise taxpayers that the proposed assessment will follow if the IRS determines the taxpayer to be responsible. If the taxpayer disagrees with the determination, the letter provides two choices to resolve the situation informally, by providing additional information to the revenue officer within 10 days, or formally, with a written appeal to protest the proposed action. Letter 1153 describes the items that should be included in the written appeal and the timeframe for submitting the appeal request.

TAXPAYER ADVOCATE SERVICE COMMENTS

The IRS has made significant strides in improving the clarity of notices issued to taxpayers and continues to take positive steps, such as incorporating external input into the notice change process, testing simplified notices to assess if they meet customer needs and standardizing the language and layout of notices. However, the National Taxpayer Advocate remains concerned about the lack of clarity in millions of notices the IRS sends to taxpayers annually. The continued failure to communicate effectively through notices causes undue taxpayer burden, IRS re-work, and frustration with the tax system. This impact is all the more significant as the IRS increasingly communicates with taxpayers *through notices as opposed to face-to-face or by telephone.*[44] *TAS is concerned with both the methodology the IRS uses to select notices for redesign as well as the emphasis in the redesign process.*

With respect to the selection of notices for the redesign process, the IRS comments indicated that it has developed a process for prioritizing the simplification of notices, which applies weighted criteria linked to the IRS' three balanced measures: customer satisfaction, business results and employee satisfaction.[45] *Balancing between these measures may not be the best way to approach notice redesign. The IRS redesign effort needs to return to basics and reflect the common sense principle that the fundamental purpose for sending notices is to communicate with taxpayers. For the IRS to communicate more effectively, the notice redesign process needs to take into consideration the perspectives of taxpayers and their representatives throughout the redesign process. Each redesigned notice needs to be subjected to a process that involves taxpayer or representative (user) input at various stages of notice development. Through this process, the IRS would learn about taxpayer notice expectations and be able to structure its notices to fit these expectations. This process could take the form of a learning lab which could test how different groups of taxpayers actually interact with notices – i.e., Where do they get stumped? How many times must they read something before they understand?*

Some notices are confusing on their face and ought not to be used. We have provided an example of one style of IRS notice (CP 207) that informs the taxpayer that he or she may have done something wrong, provides the taxpayer a menu of possibilities, and informs the taxpayer that in order to avoid penalties the taxpayer must prove that he or she did not take any of the actions listed in the menu. Other communications are of such importance, that they must contain detailed case-specific information as to how the IRS arrived at its conclusions. We referenced Letter 1153 (proposing to assess personal liability in employer trust fund cases) in this category, and we provided the number of TAS cases pertaining to trust fund recovery assessments. TAS does not equate its trust fund case inventory to failures with Letter 1153. Rather, we referenced these cases as illustrative of a particular area of the law where taxpayers do not understand the investigative process or its implications. The trust fund investigatory process, for the most part, takes place outside the presence of the potential responsible person, and unless the responsible person files an appeal, he or she may not be informed as to the IRS' factual conclusions that support the proposed responsible person determination. For this reason, Letter 1153 needs to contain case-specific information. This taxpayer-oriented analysis is vital for effective notice design.

In the IRS' comments, it indicates that it has improved 13 math error notices. The National Taxpayer Advocate has paid particular attention to math error notices for a number of reasons.[46] *Math error procedures differ from deficiency procedures in that the IRS can summarily assess the tax*

[44] See Taxpayer Access – Face-to Face Interaction and Taxpayer Access – Remote Interaction, *supra*.

[45] The balanced measures system was adopted as part of the IRS reorganization effort and utilizes three criteria: customer satisfaction, business results and employee satisfaction. IRM 1.5.1.5.

[46] For a detailed discussion of this issue, see the National Taxpayer Advocate's *2002 Annual Report to Congress*, Most Serious Problem, Math Error Authority, 25-31, and Key Legislative Recommendation Math Error Authority, 185-197.

in the case of a math or clerical error.[47] *If the taxpayer does not respond to the IRS within 60 days of the notice to request abatement, the taxpayer loses the ability to appeal the IRS' decision in court.*[48] *Thus, poorly drafted math error notices can confuse taxpayers and can also cause a taxpayer to fail to exercise his or her appeal rights. Additionally, when Congress expanded the IRS' math authority in 1976, both the House Committee on Ways and Means and Senate Finance Committee explicitly noted their the expectation that IRS math error notices would include line-by-line explanations to the taxpayer of the math error.*[49] *We note that some of the revised math error notices lack the specificity that Congress intended.*

The IRS can, in fact, design extremely clear and taxpayer-friendly notices. Several EITC notices are examples of how notices should be developed, tested, and designed. The Wage and Investment Division (W&I), Small Business/Self-Employed Division (SB/SE), Taxpayer Advocate Services, and the Office of Appeals worked in a cooperative effort on an EITC Notice Redesign Team to improve EITC notices in the EITC Examination process. TAS was particularly concerned about a 1999 IRS initiative to combine two notices, i.e. the "30-day" notice and the initial contact letter, into a single notice (the Combo Letter).[50] *The 30-day notice gives the taxpayer 30 days to request an appeal within the IRS. Since the taxpayer has not yet responded to the IRS request for information, it would be premature for the taxpayer to request an appeal, yet the Combo Letter could force the taxpayer to either take a premature appeal or lose his or her appeal rights. The IRS took the commendable step of eliminating the Combo Letter from the EITC Examination process, effective for the 2005 filing season. However, the National Taxpayer Advocate repeats her recommendation that the Combo Letter be eliminated from other IRS correspondence examination procedures.*

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations to improve notice clarity:

- *Establish a notice improvement learning lab through which the IRS can work directly with taxpayers and understand their perceptions and expectations at the time that notices are redesigned, thereby enabling the IRS to identify which parts of notices are confusing to taxpayers.*
- *Expand avenues for taxpayers and their representatives to comment on the quality of specific notices, to include the dedication of a portal on the IRS Internet site on which taxpayers can describe confusing notices and provide timely reports of complaints to IRS teams working on notice issues.*

[47] The correction to a math or clerical error is assessed immediately and the taxpayer has 60 days within which to request abatement. If the taxpayer requests abatement, the IRS must follow deficiency procedures, which provide the taxpayer with the opportunity to litigate the matter in the Tax Court. IRC § 6213(b).

[48] IRC § 6213(b).

[49] Tax Reform Act of 1976, Pub. L. No. 94-455, S. Rep. 94-938(I), 376; H. Rep. 94-658, 291.

[50] In the 2003 *Annual Report to Congress,* the National Taxpayer Advocate listed Combo Letter as a Most Serious Problem affecting taxpayers. National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 87; *see also* National Taxpayer Advocate, *Fiscal Year 2005 Objectives Report to Congress*, Publication 4054 (Rev. 06-2004) 26.

- *Expand the criteria for determining which notices to redesign to include: (1) number of taxpayers affected, (2) impact on taxpayer compliance, (3) impact on taxpayer rights, (4) impact on taxpayer burden if implemented, (5) impact on other IRS operations downstream; (6) error rates on notices, and (7) costs to implement the proposal.*
- *Eliminate notice formats which on their face fail to describe in detail why the IRS is issuing the notice.*
- *Research the downstream consequences to the IRS and taxpayers of confusing and poorly drafted notices.*
- *Enhance specificity in math error notices to conform to Congressional intent that math error notices provide sufficient detail and clarity so that taxpayers are able to determine precisely what items were changed, and why.*
- *Eliminate the use of the Combo Letter in all correspondence audits.*

PROBLEM

TOPIC C-12

MOST SERIOUS PROBLEM: ERRONEOUS AND MISCALCULATED COLLECTION STATUTE EXPIRATION DATES

RESPONSIBLE OFFICIALS

Henry O. Lamar, Jr., Commissioner, Wage and Investment Division
Kevin M. Brown, Commissioner, Small Business/Self-Employed Division

DEFINITION OF THE PROBLEM

The IRS is miscalculating collection statute expiration dates on certain taxpayer accounts. The collection statute expiration date (CSED) (pronounced within the IRS as *"see-said"*) represents the date beyond which the taxpayer is no longer obligated on a tax debt and the IRS must cease its collection efforts.[1]

Miscalculations of CSEDs can negatively affect a taxpayer when the CSED on a particular tax erroneously appears on the IRS computer systems as being within the statute of limitations period, resulting in continued IRS collection activity, when in fact the statutory period for collections has expired. An incorrectly calculated CSED can also negatively impact the IRS when the CSED is miscalculated to reflect that the statute of limitations period has expired when in fact the debt is still collectible.

After TAS case advocates noted a large number of incorrect CSEDs on taxpayer accounts, the National Taxpayer Advocate raised the issue of systemic problems in the calculation of CSEDs with the appropriate IRS officials. With the cooperation of the IRS, a task force was established to identify and correct miscalculated CSEDs as well as identify and propose solutions to the systemic causes for the miscalculations. Although only a partial review of taxpayer accounts has been conducted to date, the task force has identified thousands of taxpayers with incorrect CSEDs.

Incorrect CSEDs have resulted from two closely related circumstances: first, the failure of IRS systems and training to keep pace with changes in the laws that affect the calculation of CSEDs; and second, inconsistent interpretations of the law as to what the correct CSED should be under certain circumstances. The circumstances resulting in incorrect CSEDs will be set out below in greater detail, along with actual examples of TAS cases involving CSED miscalculations.

ANALYSIS OF CSED PROBLEMS

CSEDs Generally

The Internal Revenue Code allows the IRS 10 years from the assessment date of the tax to collect assessed but unpaid tax.[2] This date is known within the IRS as the "CSED." CSEDs are computed by two methods: automatically by IRS computer systems and in

[1] IRC § 6502(a)(1).

[2] *Id.*

certain circumstances, manually by IRS personnel.[3] Establishing the CSED initially is not difficult because the IRS computer systems simply calculate 10 years from the assessment date. However, the task of computing a CSED is complicated somewhat by intervening changes in the law and by the different factual circumstances of taxpayers that affect the calculation of CSEDs.

The Internal Revenue Code provides for a suspension in the running of the 10-year collection statute of limitations period upon the occurrence of certain events to compensate for the fact that the IRS must suspend collection actions during these periods. These events include the following actions taken by a taxpayer:

- Filing of bankruptcy petition;[4]
- Submission of an Offer in Compromise (OIC);[5]
- Request for Collection Due Process hearing (CDP) or seeking judicial review of the results of a CDP hearing;[6]
- Seeking protection from a joint income tax liability;[7] and
- Requesting an installment agreement or filing an appeal on the rejection of an installment agreement.[8]

These events, which can occur in isolation or in combination with one another (*e.g.* an offer in compromise can be submitted in conjunction with a CDP hearing), require a change to the original CSED on the IRS Individual Master File (IMF) or IRS Business Master File (BMF), depending on whether the taxpayer is an individual or a business, respectively. Changes to the tax laws have created an additional layer of complexity onto CSED calculations.

Changes to Laws Relating to CSEDs:
Internal Revenue Service Restructuring and Reform Act of 1998

The IRS uses a tax collection waiver form (Form 900) to extend the CSED on delinquent tax accounts beyond the 10 years allowable by law for tax collection. These waivers could be secured on any account at any time during the life of an open CSED, if it was determined that a waiver was necessary to protect the government's interest. Waivers were most often secured with installment agreements where full payment of the account would extend beyond the ten year statute.[9] Waivers were also secured when an account was

[3] IRM 25.6.9.3. (1-1-03).

[4] IRC § 6503(h).

[5] IRC §§ 6331(i)(5) and 6331(k)(1).

[6] IRC § 6330(e)(1); IRC § 6320)e)(1).

[7] IRC § 6015(e)(2).

[8] IRC § 6331(k)(2).

[9] An Installment Agreement is a type of collection alternative which allows the taxpayer to pay the tax liability in installments over a period of years. IRM 5.19.1.5.4.1.

being reported "currently not collectible" (CNC) for the sole purpose of protecting the IRS' time to collect the balance due. Prior to the IRS Restructuring and Reform Act of 1998 (RRA 98), there was no statutory or regulatory limit as to how far the 10 year collection statute of limitations period could be extended. There are documented cases within TAS where IRS collection personnel secured waivers for many years beyond the 10 year limit, some extending an account to the year 2050.

In 1998, Congress imposed restrictions precluding the IRS from requesting a taxpayer to sign a waiver form (IRS Form 900) unless the waiver was sought either in conjunction with an installment agreement or in conjunction with a release of a levy.[10] Thus, the IRS could no longer demand waivers as a condition of an offer in compromise (OIC).[11] In the case of waivers secured in conjunction with an OIC before December 31, 1999, RRA 98 § 3461(c)(2) provided that any such waiver would expire on the later of the expiration of the 10 year collection statute of limitations period or December 31, 2002.

These provisions invalidated some CSEDs that were extended beyond December 31, 2002. For example, assume a taxpayer had an unpaid tax debt with a CSED of December 30, 2000, and that on September 30, 1995, the taxpayer submitted an OIC, which the IRS accepted on September 30, 1998. In conjunction with the OIC, the taxpayer was required to consent to a suspension of the CSED for the period during which the offer was pending, plus one year (an extension of four years in this example). The taxpayer subsequently defaulted on the payment obligations under the OIC. Prior to RRA 98, the correct CSED would have been December 30, 2004. The change in the law brought about by RRA 98 § 3461(c)(2) meant that the waiver expired on December 31, 2002, and the IRS no longer had the additional period to collect the tax.[12]

RRA 98 brought another change in the law which affected the calculation of CSEDs in conjunction with offers in compromise. Prior to RRA 98, the Form 656, Offer In Compromise, contained a provision that required a taxpayer to waive the statute of limitations period for the time the offer was under consideration by the IRS, plus an additional

[10] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3401, 112 Stat. 685 (now codified as IRC § 6502(a)).

[11] Another provision of RRA 98 suspended the collection statute of limitations period while an OIC was pending plus an additional 30 days. As a result of a change in the law, it was no longer necessary for the IRS to request a waiver in conjunction with the submission of an OIC. The IRS can still demand waivers from taxpayers in conjunction with installment agreements, however, the IRS has established an internal policy that it will not extend waivers for more than five years plus one beyond the CSED. IRM 25.6.18.2.; *see also* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 107.

[12] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3461(c)(2), 112 Stat. 685 provides as follows:

> If, in any request to extend the period of limitations made on or before December 31, 1999, a taxpayer agreed to extend such period beyond the 10 year period referred to in section 6502(a) of the Internal Revenue Code of 1986, such extension shall expire on the latest of –
>
> (A) the last day of such 10-year period;
>
> (B) December 31, 2002; or
>
> (C) in the case of an extension in connection with an installment agreement, the 90th day after the end of such period of such extension.

year.[13] In other words, prior to 1998, the statute of limitations period was suspended for the period during which the offer was considered and extended for an additional year after the determination was made on the offer. Effective January 1, 2000, RRA 98 § 3462 provided that the collection statute of limitations period was suspended for the time that the offer is being considered by the IRS, plus an additional 30 days.[14] RRA 98 thus reduced the period for which the CSED was extended from one year to 30 days for offers-in-compromise submitted or pending on January 1, 2000.[15]

Community Renewal Tax Relief Act of 2000 and the Job Creation and Worker Assistance Act

After RRA 98, the collection statute of limitations period on a tax liability would be suspended pursuant to IRC § 6331(i) while offers-in-compromise or installment agreements were pending approval of the IRS. However, the Community Renewal Tax Relief Act of 2000 (CRTRA) modified IRC § 6331(i) effective December 20, 2000, so that the statute of limitations period was not suspended while offers for settlements were pending or in effect.[16] More recently, the Job Creation and Worker Assistance Act of 2002 amended IRC § 6331(k) effective March 9, 2002, to reapply the IRC § 6331(i)(5) suspension while offers are pending.[17]

INCORRECT CSEDS AFFECTED BY CHANGES IN THE LAW

TAS has uncovered numerous incorrect CSEDs where taxpayer accounts failed to reflect the changes in the laws, many times involving taxpayers who had submitted offers in compromise to resolve a tax liability. The Offer in Compromise (OIC) Program provides a means by which taxpayers can settle a liability for less than the amount due.[18] Changes in the law impacting the calculation of CSEDs require the IRS to update its systems and adjust the accounts of affected taxpayers. In many cases, however, these adjustments were not made. An example of a typical TAS CSED case is set forth below.

[13] The justification for the waiver was IRS policy of withholding collection activity while the offer was under consideration. IRS Policy Statement P-5-97 (1959); *see also* Treas. Reg. § 301.7122-1(d)(2) (1960).

[14] IRC §§ 6331(i)(5) and 6331(k)(1).

[15] For those taxpayers who extended the CSED in conjunction with an offer-in-compromise that was submitted and ruled on prior to January 1, 2000, the CSED expired on the later of December 31, 2002 or the original CSED date.

[16] Community Renewal Tax Relief Act, P.L. 106-554 (Consolidated Appropriations Bill for 2001). For related analysis, *see* Arthur H. Boelter, *Representing the Bankrupt Taxpayer*, 1 Rep. Bankr. Taxpayer § 5:7 (2004).

[17] Although the suspension of the collections statute of limitations period was reinstated for offers-in-compromise, it was not reinstated for installment agreements. Instead, the IRS secures written agreements of the waivers in the case of installment agreements. Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107-147); *see* IRM 5.14.2.1 for IRS procedures related to waivers and installment agreements.

[18] The administration of the Offer in compromise (OIC) program is again listed as a Most Serious Problem affecting taxpayers. *See* Offers in Compromise, *infra.*

> **Example:** An employer was assessed a penalty for failure to file Forms W-2 (Wage and Tax Statement) on 9/21/92. The original 10 year collection statute expiration date (CSED) for this assessment was 9/21/02. On 12/15/94, the employer filed an offer in compromise to settle this account. The IRS rejected the offer on 2/26/98. In connection with the submission of the offer, the taxpayer had signed a waiver that extended the collection statute of limitation period for the period the offer was pending plus one year. Thus, the IRS extended the CSED until 12/1/2006. As a result, the account remained open and collection action continued. The statute of limitations period should have terminated on December 31, 2002, pursuant to RRA 98 § 3461(c)(2).
>
> TAS attempted to correct the CSED, but many IRS campuses (service centers) will not correct a CSED problem without an opinion from area counsel authorizing the correction. The IRS campus in this case indicated that it has neither the guidance nor the authority to correct an erroneous CSED without a counsel opinion. Eventually an opinion from counsel was obtained confirming the need for a CSED correction.

The above example illustrates a problem with IRS data systems that failed to terminate the running of the collection statute of limitations period as of December 31, 2002 pursuant to RRA 98 § 3461(c)(2). The example also illustrates another problem encountered by TAS case advocates: Even when IRS personnel agree with TAS advocates that a CSED is incorrect, some IRS campuses require a counsel opinion to authorize the CSED correction because there is no provision in the Internal Revenue Manual (IRM) authorizing and explaining how to correct CSEDs. The IRS needs to revise its IRM procedures to properly instruct its employees about clearly erroneous CSEDs and to grant IRS personnel the ability to make these corrections without a counsel opinion.

Incorrect CSED calculations have also been identified on numerous accounts with installment agreements and Form 900 (Tax Collection Waiver). As described above, RRA 98 limited the circumstances under which the IRS could request a taxpayer to sign a Form 900 to extend the collection statute of limitations period to instances where the waiver was secured in conjunction with an installment agreement or in conjunction with the release of an IRS levy.[19] RRA 98 also provided that extensions of the collections statute of limitations period entered into before December 31, 1999, would expire on the later of 10 years from the date of assessment or December 31, 2002.[20] The effect of this provision was to invalidate waivers beyond December 31, 2002, on the accounts of many taxpayers whose waivers were not in conjunction with installment agreements or the release of a levy.

[19] IRC § 6502(a)(2).

[20] The Internal Revenue Service Restructuring and Reform Act of 1998, § 3461(c)(2), Pub. L. No. 105-206.

In determining whether a taxpayer signed a Form 900 *in conjunction with* an installment agreement, IRS policy has been that if the waiver form and the installment agreement were filed within 120 days of each other, they would be determined to be in conjunction with one another and such accounts would not be subject to the December 31, 2002 CSED expiration.[21] TAS has identified cases where the IRS incorrectly determined that Form 900 waivers were in conjunction with Installment Agreements. An example of such as case is set forth below.

> **Example:** A taxpayer who had liabilities for multiple years (1988 through 1991) signed a waiver form (F-900) on 6/21/1998, extending the CSEDs on the accounts by over 50 years to 12/31/2050. The taxpayer had not entered into an installment agreement and did not have a levy released, and therefore, the waiver should have been terminated effective December 31, 2002 pursuant to RRA 98. However, the taxpayer still received delinquency notices on the liabilities after December 31, 2002, and the taxpayer continued to make payments beyond December 31, 2002, including 18 voluntary payments of $175 each between 1/18/2003 and 11/2/2003. Additionally, the taxpayer's income tax overpayment of $1,511 from his 2002 tax return was offset against the debt that was no longer collectible. The IRS data systems did not effectively account for the changes in the law brought about by RRA 98. TAS ultimately intervened in the case with the result that the CSED was properly reset to 12/31/2002 and the taxpayer was refunded all the payments made in 2003.

Incorrect CSEDs have also been uncovered in instances where taxpayers submitted requests for installment agreements. When an installment agreement is submitted, the running of the collections statute of limitations period must be suspended until the IRS makes a determination on the agreement, plus an additional thirty days if the installment agreement request is denied.[22] TAS has identified cases in which the IRS systems failed to restart the running of the collections statute of limitations period thereby resulting in incorrect CSEDs on the IRS systems. An example of a TAS case is set forth below.

> **Example:** The IRS assessed tax on 6/19/89 based on the taxpayer's income tax return for calendar year 1988 resulting in a 6/19/99 CSED (10 years from the original assessment of 6/19/89). The taxpayer was audited and an additional tax was assessed on 10/22/90 resulting in a 10/22/00 CSED for the additional tax. This account should have two CSEDs, however, the IRS systems used the 10/22/00 CSED to control both tax assessments. When the

[21] Internal Revenue Service, Payment Compliance Memorandum (July 2, 2003).

[22] IRC § 6331(k)(3).

> taxpayer requested an installment agreement on 2/29/00, the IRS made an indication on the taxpayer's account so that collection action would cease. The taxpayer's account was never marked to indicate an ultimate determination on the taxpayer's request for an installment agreement. Because the disposition of the taxpayer's request was not indicated on the taxpayer's account, the IRS systems did not reflect that the running of the collection of statute of limitations period had resumed. As a consequence, the IRS continued taking collection actions against the taxpayer, including offsetting against a refund that was due the taxpayer in 2004. TAS was eventually successful in having the taxpayer's account properly marked to show an installment agreement was denied to the taxpayer and that the IRS data systems should have reflected that the statute of limitations period had begun running again and that the CSEDs for both assessments had expired.

The above example also demonstrates that the IRS has a problem tracking multiple CSEDs for the same tax period. In the example, the taxpayer had one CSED for the self-assessed tax as shown on the taxpayer's return and another CSED for the additional tax assessed as a result of the IRS audit. However, IRS systems are unable to account for the fact that there are two CSEDs for the same tax period, and the IRS utilizes the latest of the different CSEDs to control the account, even though this could result in collection activity on an account where the statute of limitations has expired for part of the tax liability.

Incorrect CSED calculations also were identified in other situations where IRS procedures cannot or will not take into consideration changes in the relevant law related to CSEDs. For example, TAS has encountered cases where the CSED was incorrect because the IRS data systems could not keep track of multiple overlapping events, each affecting the computation of the CSED, such as a submission of an OIC followed by a bankruptcy. All of the events that might impact a CSED calculation are given special IRS codes used by the IRS to systemically update and annotate a taxpayer's account. However, the IRS data systems do not accurately compute CSEDs when two or more such events overlap. The calculation of the correct CSED in such cases can be very complex. The IRS has acknowledged the existence of system problems in calculating CSEDs when multiple events overlap.

The complexity of the calculation of CSEDs is one of the reasons that taxpayers who come to TAS or to tax practitioners do not specifically identify the CSED as the source of their tax problem. Taxpayers are often not aware what the law is with respect to the collection statute of limitations period and certainly are not aware how changes in the laws have affected CSED calculations. For this reason, the IRS must ensure that its systems accurately compute CSEDs and that its employees are sufficiently aware of the challenges that incorrect CSEDs present. Further, IRS employees should be trained to recognize situations in which incorrect CSEDs might occur and be directed to correct the erroneous CSED.

To date, the IRS has had difficulty quantifying the number of incorrect CSEDs caused by the failure of the IRS systems to keep pace with the changes in the law. The IRS has had better results calculating the number of taxpayers affected by conflicting interpretations of the laws.

CONFLICTING INTERPRETATIONS OF THE LAW

Incorrect CSEDs caused by misinterpretations of the law have been found on thousands of taxpayer accounts. TAS has identified at least two different legal issues relating to the calculation of CSEDs that have been the subject of conflicting interpretation. The first issue involves the situation where the IRS files a Substitute For Return (SFR) on behalf of the taxpayer when the taxpayer failed to timely file a tax return.[23] The second issue involves a reassessment of the tax after a taxpayer defaults under an offer in compromise (OIC) entered into with the IRS.

Substitutes for Returns

Pursuant to IRC § 6020(b), after a taxpayer fails to file a timely income tax return, the IRS executes a Substitute for Return (SFR). The IRS issues a 30 day notice proposing the tax assessment. After that, the IRS issues a statutory notice of deficiency to the taxpayer providing the taxpayer a right to petition the proposed deficiency to the United States Tax Court within 90 days, without first paying the tax.[24] Provided that the IRS assesses the tax, a CSED will be established 10 years from the date of the SFR assessment.[25] Because SFRs are based only on the information that the IRS has available to it, such as Forms W-2, the SFR may tend to overstate the true tax liability. The IRS encourages taxpayers disputing an SFR assessment to file their original returns reflecting all appropriate income, deductions and exemptions.[26] Consequently, taxpayers will often file their own original tax returns showing a lesser amount of tax due, and where warranted, the IRS will reduce the assessed tax.[27] When the taxpayer files his or her original return showing a lesser amount due, there is no new assessment of tax, and therefore no reason for the statute of limitations to be changed from the date of the initial IRS assessment.[28] However, the IRS Chief Counsel has offered inconsistent interpretations on this issue.[29] While differing

[23] After TAS raised the issue with the IRS, a task force comprised of representatives from TAS, the Small Business/Self-Employed Division and the Wage and Investment Division conducted a computer based search of cases falling within this category, and to date, have identified well in excess of 10,000 cases with incorrect CSEDs.

[24] A statutory notice of deficiency is intended to furnish legal notice that such deficiency exists to the person liable for the payment of the tax. IRC § 6212; *see also* IRM 4.4.7.9 (02-08-1999); *see also Spurlock v. Com'r*, 118 T.C. 155 (2002) (holding substitutes for returns (SFRs) are subject to deficiency procedures).

[25] IRS, CCA 200421002, April 9, 2004.

[26] IRM 5.19.1.3.2.5.

[27] *Id.* (directing IRS employees to encourage taxpayers disputing SFR assessment to file original return with appropriate exemptions, deductions and filing status).

[28] IRS, CCA 200421002, April 9, 2004.

[29] *See* CCA 200139018, dated July 10, 2001 which concluded that the assessment date is the date of the return filed by the taxpayer; this conclusion was reconsidered in CCA 200149032, dated October 22, 2001, which concluded that the correct date for the running of the 10 year statute of limitations period is the SFR assessment date. The memorandum dated October 22, 2001 was recently reaffirmed in IRS CCA 20042102, dated April 9, 2004.

interpretations in matters relating to tax law are not unusual, once this issue was resolved within the IRS, there were no system-wide instructions communicated to IRS employees. The result was that different campuses used different interpretations of the law. For example, while the IRS Office of Chief Counsel had conclusively determined as of October 2001 that the correct CSED was the SFR assessment date, TAS has uncovered IRS desk guides used by campuses and dated November 2003 which still instructed employees that no CSED was established with the SFR assessment date and the legal CSED only begins running when the taxpayer files a return. The result has been thousands of taxpayer accounts with incorrect CSEDs. An example of a typical TAS case is set forth below.

> **Example:** The taxpayer was originally assessed tax under the Substitute for Returns (SFR) program on 1/4/1993 with a CSED of 1/4/2003. On 2/19/2001, the original tax assessment was partially abated as the result of the taxpayer filing his own return on 8/8/2000. The taxpayer's account shows a partial abatement of tax by IRS on 2/19/2001. However, the account was also marked with a new CSED of 2/19/2011 (10 years from the abatement date). TAS was not able to have this CSED corrected without an advisory opinion from local area counsel concurring with the CSED calculation. TAS sought counsel advice and ultimately, the CSED was corrected.

After TAS raised these issues, the IRS was able to conduct a search of IRS records for those taxpayers with incorrect CSEDs as a result of the misinterpretation of the law with respect to SFR assessments. The initial review uncovered thousands of such accounts. To date, the IRS has not corrected these accounts or taken steps to ensure that no additional incorrect CSEDs are generated.

Defaulted OICs

Another recurring example of incorrect CSED calculations involves taxpayers who have defaulted on their OICs and the IRS has incorrectly reassessed the original tax liability, causing a new 10 year collection statute of limitations period to be imposed on the taxpayer. When an OIC is accepted, the taxpayer must agree to make timely payments as required under the offer and remain in full tax compliance for the next five tax years.[30] However, the tax that is the subject of the OIC cannot be abated until all of the terms of the offer agreement have been satisfied.[31] TAS has learned that prior to 1994 the only way to reduce the tax on the IRS database was to enter an abatement code. As a result, if an offer defaulted after the tax was abated, the method used to reflect that the tax was again owed was to enter a code that resulted in a reassessment and a new 10 year statute of limitations, which is incorrect. TAS has been informed that after 1994 codes were made

[30] Treas. Reg. § 301.7122-1.

[31] *Finen v. Comm'r*, 41 T.C. 557, 560-61 (1964); *Robbins Tire & Rubber Co. v. Comm'r*, 52 T.C. 420, 435 (1969).

available to IRS personnel that would not produce an abatement of the tax after an OIC was entered into, and would not result in a reassessment in the event the OIC was defaulted. However, TAS case advocates have identified numerous cases where collection activity is taking place even though the collection statute of limitations was erroneously extended for an additional 10 years. In other words, while the IRS may have addressed the cause of the problem, it did not correct the CSEDs on the system. An example of such a case is set forth below.

> **Example:** A taxpayer operated his business as a sole proprietor with employees and was assessed certain taxes relating to various Forms 941 (Employer's Quarterly Federal Tax Return) and Form 940 (Employer's Annual Federal Unemployment Tax Return) for multiple tax periods on 12/30/91, 3/9/92, 3/23/92, and 6/22/92.
>
> On 12/31/1992, the taxpayer submitted an offer in compromise (OIC), which the IRS accepted on 5/28/1993. At this point, the IRS abated the balances due to reflect the amount agreed upon in the offer. On 11/13/1997, the taxpayer failed to meet the terms of his offer; specifically, he did not stay in compliance (timely filing and paying) within five years of the offer being accepted. When the offer defaulted, the IRS reassessed the tax, penalties and interest with a new assessment date of 12/22/1997 and setting a new CSED date of 12/22/2007. The IRS filed a Notice of Federal Tax Lien indicating an incorrect CSED of 12/22/2007.
>
> As a condition of an unrelated property transaction, the taxpayer was required to pay off all outstanding liens. Although the CSED was incorrect, the taxpayer had to pay the outstanding balance due to the IRS in order to complete the property transaction. However, the taxpayer later sought assistance from TAS which obtained a refund of the taxpayer's payments collected beyond the CSED and fully resolved the account balances.

The IRS has indicated that CSED mistakes demonstrated by the above example would not be repeated after the new procedures were instituted in 1994. However, the IRS is still engaged in collection actions in cases that were subject to the old system. Additionally, even though new procedures were supposed to prevent such mistakes from occurring after 1994, TAS case advocates continue to encounter defaulted OIC cases with new ten year collection periods as of the reassessment date. Since many OICs are manually monitored, the problem may have less to do with the IRS data system and more to do with a lack of training of IRS personnel.[32]

[32] IRM 5.19.7.3.23.2.

CONCLUSION

Many of the issues identified by the National Taxpayer Advocate in the Annual Report to Congress involve the difficult issue of resource allocation. While the CSED problems can also benefit from additional resources, such as system upgrades to better identify incorrect CSEDs, many of the CSED problems appear to stem from a lack of information and proper training about CSED issues. For example, there is no provision within the Internal Revenue Manual that addresses the correction of a CSED. In the situations described above that result in incorrect CSEDs, the IRS campuses take different approaches to correcting the problems. Some campuses cooperate with TAS when incorrect CSEDs are brought to their attention, while others require IRS counsel opinions before the changes to taxpayers' accounts are made and still other campuses take no action at all. The IRS needs to establish uniform guidelines for correcting CSED problems.

Additionally, IRS officials in some campuses have differing views concerning the law in certain areas related to CSEDs. When the IRS realizes that a segment of its operating functions are taking inconsistent stances on an area of the law, as was the case in SFR assessments, it must find a way to instruct all of its employees about the correct position. Counsel memoranda directed to a few IRS officials may not be the best way to educate IRS personnel about complex aspects of the law.

Taxpayers and tax practitioners are often unaware of the incorrect CSED issues, and the discovery of CSED mistakes by TAS and tax practitioners has been by happenstance. Consequently, measuring the extent of the CSED problems has been challenging. The IRS is aware of the CSED problems and has authorized a joint task force to analyze the nature and extent of the problem. The task force is attempting to quantify the SFR assessment problem, and its initial review identified thousands of taxpayers with incorrect CSEDs. The IRS is also evaluating ways to quantify the other CSED problems. This is an important and commendable first step, but the IRS should be encouraged to develop mechanisms to correct the accounts of these taxpayers and to prevent future incorrect CSEDs through employee training and systems modifications and upgrades.

IRS COMMENTS

The IRS agrees that there are systemic and manual complexities surrounding Collection Statute Expiration Date (CSED) calculations, and we are actively engaged with all stakeholders in efforts to correct the problems. We have requested several systemic modifications and upgrades and are working with programmers to address these concerns. In the interim, we have partnered with the Taxpayer Advocate Service (TAS) and have established cross-functional teams to develop mechanisms to correct affected taxpayer accounts and to prevent future incorrect CSEDs.

Through these teams, the IRS is taking the following actions to correct identified problems:

- Developing an interactive CSED tool to ensure uniformity in calculations across all functions.
- Conducting a complete overhaul of Internal Revenue Manual (IRM) CSED procedures.
- Continuing case identification and procedures for correcting accounts with incorrect CSEDs.
- Preparing additional training on CSED issues.

The IRS is committed to correcting CSED problems that can be quantified; addressing the root causes contributing to the incorrect CSED calculations, and providing cross-functional procedures and training for the prevention of future errors.

TAXPAYER ADVOCATE SERVICE COMMENTS

The IRS' response to the CSED problem is very encouraging and is, in our opinion, a model for problem-solving, particularly where the issue involves several IRS functions and has technical implications. The IRS has taken positive steps to address the numerous CSED issues that are causing incorrect CSED calculations on taxpayer accounts. We are pleased to participate as part of the cross-functional team addressing the CSED problems.

RECOMMENDATIONS

In order to ensure that the CSED issues are fully addressed, the National Taxpayer Advocate makes the following recommendations:

- *The overhaul of the IRM should include descriptions of the legal or technical issues which have given rise to incorrect CSEDs, along with examples of each type of incorrect CSED category, and should include procedures for expedited managerial approval of CSED changes where the adjustment is attributable to one of these categories.*
- *The IRS should develop training on CSED issues for IRS personnel who work on taxpayer accounts.*

- *The IRS should ensure that taxpayers that have been negatively impacted by incorrect CSED calculations are identified, account problems are corrected, and funds erroneously collected are returned. The cross functional team should follow through expeditiously with the account extracts needed to identify those taxpayer accounts that need correction.*
- *To avoid situations where counsel guidance and revisions to counsel guidance do not filter down to all levels of employees who are impacted by the guidance, all counsel memoranda that impact taxpayer accounts should be accompanied by a summary description of the guidance in common sense terms, i.e. not in "legalese," which should be e-mailed to all affected personnel.*

We are committed to work with the operating divisions until the CSED problems are resolved and appreciate their willingness to address this issue.

PROBLEM TOPIC C-13 — MOST SERIOUS PROBLEM: APPLICATION AND FILING BURDENS ON SMALL TAX-EXEMPT ORGANIZATIONS

RESPONSIBLE OFFICIALS:

Steven T. Miller, Commissioner, Tax Exempt & Government Entities Division

DEFINITION OF PROBLEM

Application for Tax-Exempt Status

Organizations applying for tax-exempt status from the IRS must follow a lengthy, complicated process, which can adversely affect their ability to raise funds and begin operations. If an organization lacks exempt status, potential donors cannot deduct contributions and therefore may be unwilling to provide start-up funding.

Over 400 Taxpayer Advocate Service (TAS) cases in FY 2004 dealt with problems for tax-exempt status applications, a 21 percent increase from FY 2003.[1] In these cases, organizations came to TAS because: (1) their applications were delayed and they did not receive a satisfactory explanation about the delays from the IRS, or (2) they requested expedited processing of tax exempt-status because of the lengthy processing time.

Application delays can impose a significant burden on small tax exempt organizations. Most tax-exempt organizations are small entities that operate locally with limited resources, modest budgets and volunteer labor.[2]

Tax-Exempt Filing Complexity

The information required of tax-exempt entities by the IRS can be extensive and the reporting requirements complex. Form 990, *Return of Organization Exempt from Income Tax*, which certain tax-exempt organizations must file,[3] is just one example of this reporting complexity. This form contains six pages, 105 lines and 46 pages of instructions. The estimated time to prepare and complete this form is 213 hours and 56 minutes, or slightly more than 26 days.[4]

Outreach and Education

The National Taxpayer Advocate is also concerned about the outreach and education provided to tax-exempt organizations in light of the tax compliance complexities these organizations face. The National Taxpayer Advocate believes that current IRS outreach and education efforts to tax-exempt organizations do provide beneficial information. She

---

1 Taxpayer Advocate Management Information System, review of 21 TAS cases (September 3, 2004).

2 *See* Elizabeth T. Boris, C. Eugene Steuerle, Urban Institute, *Nonprofits & Government Collaboration and Conflict*, 1997

3 Form 990 must be filed by organizations that have more than $100,000 in gross receipts or assets in excess of $250,000 at the end of the year. Form 990, *Return of Organization Exempt from Income Tax*, Catalog 11282Y (2003).

4 Assuming an eight hour work day. Instructions for Form 990 and Form 990-EZ, Cat. No. 22386X (2003), 44. This time estimate includes preparing and completing Form 990 including Schedules A and B.

also believes, however, that these efforts could be improved with more focused planning and formal research designed to tailor outreach and education efforts to specific segments of the tax exempt organization population.

ANALYSIS OF PROBLEM

A. Application for Tax-Exempt Status

The current tax-exempt application process is unreasonably complex and lengthy, and impacts an ever increasing number of new tax-exempt organizations.[5] In 2003, there were 1.6 million such organizations listed on the IRS Exempt Organization Business Master File, which represents an increase of over 60 percent since 1989.[6] In fiscal year 2004, the IRS received over 92,000 applications for tax-exempt status – nearly a 12 percent increase since FY 2000.[7]

Complexity

To obtain federal tax-exempt status, an organization must complete and file Package 1023, *Application for Recognition of Exemption Under § 501(c)(3) of the Internal Revenue Code*,[8] and Form 8718, *User Fee for Exempt Organization Determination Letter Request*.[9] The fee is $150 for new organizations with anticipated gross receipts of not more than $10,000, and $500 for those anticipating $10,000 or more in receipts. The organization must also be familiar with Publication 557, *Tax-Exempt Status for Your Organization*, which presents information and instructions on how to file for tax-exempt status.[10]

The application for tax-exempt status is 29 pages long (including nine different schedules), with eight pages of instructions.[11] The IRS estimates that an organization will need 126 hours and 49 minutes, or nearly 16 days, to complete the application, read and understand the applicable tax provisions, and keep the necessary records.[12] Publication 557, which explains how to complete the application, is 63 pages long.

5 *Tax-Exempt Organizations and Other Entities Listed on the Exempt Organization Business Master File, by Type of Organization and Internal Revenue Code Section, Fiscal Years 2000-2003, IRS SOI Table 22*, at http://www.irs.gov/pub/irs-soi/03db19ep.xls, last viewed on Aug. 17, 2004.

6 *See* The Urban Institute, *New Almanac Charts Nonprofit Sector*, at http://www.urban.org/url.cfm?id=900104, Sept. 17, 1997.

7 Manager Exempt Organizations Determinations, handout, Sept. 15, 2004.

8 Package 1023, *Application for Recognition of Exemption Under Section 501(C)(3) of the Internal Revenue Code*, Cat. No. 47194L (Rev. Sept. 1998).

9 IRS Form 8718, *User Fee for Exempt Organization Determination Letter Request* (Nov. 2003).

10 IRS Publication 557, *Tax-Exempt Status for Your Organization* (May 2003).

11 Applying organizations are required to complete schedules specific to their purpose. For example, if the organization is home for the aged or handicapped it would be required to complete Schedule F. If the organization was formed to provide child care, it would be required to complete Schedule G.

12 Assuming eight hour work days. Package 1023, *Application for Recognition of Exemption Under Section 501(C)(3) of the Internal Revenue Code*, Cat. No. 47194L (Rev. Sept. 1998). Additional time is necessary if the organization is a Private Foundation. *See* IRS Publication 578, *Tax Information for Private Foundations and Foundations Managers* (Jan. 1989).

This complexity leads to confusion. Over 11 percent of all calls to the IRS telephone assistance line for TE/GE customers are related to the tax-exempt application package.[13] This number is significant, considering that TE/GE consists of three major business units – Exempt Organizations (EO), Employee Plans (EP), and Government Entities (GE) – which oversee approximately three million entities, from small volunteer organizations to sovereign Indian tribes to large pension funds.

The length and complexity of the application form may present particular problems for small organizations, which are often minimally staffed and rely extensively – or exclusively – on volunteers.[14] These volunteers may not have the time or expertise to accurately complete the application.

The ten most frequent errors made by organizations applying for tax-exempt status are:

1) Failing to include the correct user fee;
2) Failing to include complete copies of organizational documents and attachments;
3) Failing to include a copy of the organization's bylaws;
4) Failing to include required signatures;
5) Failing to complete all required pages of the application;
6) Failing to complete all schedules;
7) Providing insufficient information about the organization's activities to show how the exempt purpose will be achieved;
8) Providing insufficient information about the organization's principal officers;
9) Failing to specify the organization's annual accounting period; and
10) Providing insufficient income and expense data.[15]

These ten common errors seem to encompass the entire tax-exempt application and can be attributed to the applicants' inexperience and the form's length and complexity.

IRS Processing Delays and Expedited Requests

Application Process

The IRS receives tax-exempt status applications at its campus in Covington, Kentucky, where the user fee is processed and the applications are date-stamped and entered into the Exempt Determinations System (EDS). The IRS sends the applicant a letter confirming

[13] TE/GE Customer Account Services (CAS) system; TE/GE Issue Codes, 4th Quarter FY 2004 Roll-up (Sept. 16, 2004)

[14] In 1998, for example, volunteers accounted for one-third of the total tax-exempt organization work force. Linda M. Lampkin, Thomas H. Pollak, *The New Non Profit Almanac& Desk Reference*, Overview and Executive Summary (March 1, 2002), xxix.

[15] *Top Ten Reasons for Delays in Processing Exempt Organization Applications*, at http://www.IRS.gov/charities/article/0,,id=96361,00.html, Dec. 28, 2004.

receipt and stating, "Normally, you can expect to hear from us within 120 days. If you do not, call our toll free number between the hours of 8 a.m. and 6:30 p.m. Eastern Time."[16] This letter is referred to as the "Acknowledgement Letter."

After receipt, applications are sent to the Cincinnati, Ohio office and put on the "shelf" to await screening.[17] "Screening" means verifying that the application contains all required information and deciding if the information about the organization's purpose is routine enough to make a quick determination of exempt status.[18] The IRS estimates that these so-called Merit determinations can be made in about 30 minutes.[19] Merit determinations are also possible when the organization's stated purpose is routine but the application contains minor errors that can be fixed during screening.[20] The IRS estimates that 30 percent of applications receive Merit determinations.[21]

If a Merit determination cannot be made, the application is returned to the shelf until it is assigned to a Determination Agent for further development. An application requires additional development when the organization's stated tax-exempt purpose requires more detailed information, investigation, or consideration to determine if the organization is legally entitled to exempt status. When a Determination Agent is assigned to an application, TE/GE notifies the applying organization by mail.[22] The IRS estimates that, on average, the agents take about four hours to make final determinations.[23] The IRS notifies the organization by mail when a final determination is made.[24]

Processing Problems and Delays

The tax-exempt application process described above can take substantial time. Table 1.13.1 shows the total numbers of applications awaiting screening and assigned to Determination Agents for the last four fiscal years.[25]

[16] Notice 3367 (cg) – (Rev. MAy 6, 2002).

[17] The "shelf" is a shelving unit in a room in the Cincinnati office where applications awaiting processing are placed.

[18] IRS Manager, Exempt Organization Processing, Sept. 15, 2004.

[19] *Id.*

[20] TE/GE presentation to the TAS Director of Systemic Business Advocacy, July 30, 2004.

[21] IRS Manager, Exempt Organization Processing, Sept. 15, 2004.

[22] TE/GE presentation to the TAS Director of Systemic Business Advocacy, July 30, 2004.

[23] IRS Manager, Exempt Organization Processing, Sept. 15, 2004.

[24] *Id.*

[25] EO Follow-Up Question No. 6 Response - CORRECTED REVISION, *EO Table 1 YTD Reports*, Sept. 10, 2004.

TABLE 1.13.1, APPLICATIONS FOR TAX-EXEMPT STATUS AWAITING SCREENING AND AWAITING ASSIGNMENT[26]

Category	FY 2001 (Ending 9/29/01)	FY 2002 (Ending 9/27/02)	FY 2003 (Ending 9/26/03)	FY 2004 YTD (Ending 9/2/04)
Unassigned (awaiting screening)	1,567	3,716	2,381	4,889
# of unassigned screening cases exceeding 150 days				3
Unassigned (awaiting group assignment)	5,201	1,761	3,845	6,345
# of unassigned cases exceeding 100 days				734
# of unassigned cases exceeding 150 days				3
Total unassigned	**6,768**	**5,477**	**6,226**	**11,234**

Table 1.13.1 shows increases of nearly 80 percent in both applications awaiting screening and applications awaiting assignment since FY 2003.

In a July 30, 2004, presentation to the TAS Director of Systemic Business Advocacy and other TAS employees, TE/GE reported that, on average, it takes about five days from the time an application is received in Covington to the time it is screened in Cincinnati.[27] TE/GE also reported that total application processing time was 120 days.[28] This figure is consistent with the information on the Acknowledgement Letter.[29] TE/GE also reported that average case processing time is 90 days.[30]

However, TAS cases and information at the IRS Cincinnati office indicate that these reported processing times do not accurately represent actual processing times. In FY 2004, TAS received 440 cases that were attributable to application processing problems for exempt organizations. In a sample of these 440 cases, half of the taxpayers contacted TAS because more than 120 days had passed since the IRS acknowledged receipt of the application, yet the organization had received no word about the application's status, and nothing explaining – or even informing it of – the delay.[31] Some of these organizations

[26] EO Follow-Up Question No. 6 Response - CORRECTED REVISION, *EO Table 1 YTD Reports*, Sept. 10, 2004. The inventory numbers provided are from a specific day and are continually fluctuating. According to information received from TE/GE in December, 2004, the total ending inventory on September 30, 2004 was 13,851.

[27] TE/GE presentation to the TAS Director of Systemic Business Advocacy, July 30, 2004. This average does not include applications with missing or incorrect user fees.

[28] *Id.*

[29] Notice 3367 (cg) – (Rev. May 6, 2002).

[30] TE/GE presentation to the TAS Director of Systemic Business Advocacy, July 30, 2004.

[31] Taxpayer Advocate Management Information System (TAMIS) Business Operating Division (BOD) report quarter ending March 31, 2004 (Sample Size: 87 cases had an MFT 0 (MFT is the coding used on the IRS system to identify the type of tax return filed) and had Taxpayer Advocate issue codes of 160 and 460. Of the 87 cases, every fifth case was selected resulting in a population of 19 cases for the review (21.8 percent)).

had tried to contact the IRS using the toll free number on the Acknowledgement Letter, but could not get through. This is not particularly surprising since the TE/GE toll-free help line currently answers only about half of its calls.[32] The organizations that were fortunate enough to have their calls answered contacted TAS because they did not get satisfactory information about the status of their applications. These organizations were told only that their applications had been received and were in process, and that the IRS would contact them when more information was available.[33]

The TAS cases indicate that the IRS does not inform organizations about processing delays. In fact, the IRS generally contacts an applicant when: (1) the application is received; (2) it is assigned to a Determination Agent; and (3) a final determination is made.[34] The organization is not informed of delays between receipt and assignment, even when the time between these events exceeds 120 days.

TE/GE records at the IRS Cincinnati office corroborate the TAS case data. According to these records, as of September 16, 2004:

- Over 11,000 applications were awaiting determinations, with 6,574 awaiting screening.[35]
- Applications awaiting screening had a "general receipt date" of July 24, 2004 – with some dated as early as June 29, 2004.[36]
- Approximately 5,000 cases had been screened and were awaiting assignment to a Determination Agent.
- Applications awaiting assignment had a general receipt date of April 19, 2004.
- There were over 2,500 applications awaiting determinations that had been received prior to June 30, 2004.[37]

[32] *Business Performance Review, Tax Exempt & Government Entities*, August 4, 2004, 37. Out of a call demand of over 668,000 calls only slightly over 367,000 were answered for a level of service rate of 54.9 percent.

[33] Taxpayer Advocate Management Information System (TAMIS) Business Operating Division (BOD) report quarter ending March 31, 2004 (Sample Size: 87 cases had an MFT 0 (MFT is the coding used on the IRS system to identify the type of tax return filed) and had Taxpayer Advocate issue codes of 160 and 460. Of the 87 cases, every fifth case was selected resulting in a population of 19 cases for the review (21.8 percent)). Of these same cases, one half of TAS' exempt organization application processing cases requested expedited treatment denials. Expedited treatment is discussed *infra*.

[34] TE/GE presentation to the TAS Director of Systemic Business Advocacy, July 30, 2004. Additional contacts may be made in certain circumstances, such as contacts to secure the processing fee, to get basic information during a Merit determination, etc. If an application is assigned to a Determination Agent, the Agent is to contact the applicant to inform the applicant that its case has been assigned, and to obtain additional information to make the determination. Other contacts may include contacts to secure user fees or to gather additional minor information during a Merit determination. *See also* Internal Revenue Manual 7.25.1.2.1 (Nov. 1, 2003).

[35] IRS Manager Exempt Organization Processing Inventory Sheets, Sept. 15, 2004.

[36] *Id.* The general receipt date is the date the applications are postmarked.

[37] IRS Manager Exempt Organization Processing Inventory Count, faxed Oct. 5, 2004.

The TAS and Cincinnati office information indicate that TE/GE's reported application processing numbers are not accurate. It takes much longer than five days for an application to go through the screening process, and far longer than 120 days to process the 66 percent that do not receive a Merit determination or other closure during screening. Based on Cincinnati office inventory information, applications are not being screened for at least 50 days after receipt,[38] and not being assigned for at least 150 days after receipt.[39] And once an application is assigned to a Determination Agent, it could take several additional weeks before a final determination is made.[40] Thus, 66 percent of organizations applying for tax-exempt status can expect to wait more than six months before the IRS rules on their applications.

So why does TE/GE report that the average application processing time is only 90 days?[41] If this figure is accurate, organizations are receiving determinations much earlier than the promised 120 days. TE/GE arrives at the 90 day average by blending Merit and non-Merit determination processing times[42] and does not monitor processing for Merit and non-Merit applications separately.[43] Merit determinations are made during screening and take an average of only 30 minutes. Thus blending Merit and Non-merit determinations does not present an accurate picture of processing time for the 70 percent of applications assigned to a Determination Agent. The National Taxpayer Advocate urges TE/GE to separately monitor Merit and non-Merit determinations in order to obtain more accurate and meaningful data that may lead to application processing time improvement measures.

Expedited Requests

An organization can try to accelerate the application process by requesting expedited treatment. According to the Internal Revenue Manual (IRM), expedited treatment will be granted when the organization presents a "compelling reason" why its application should be processed before others.[44] The IRM provides that expedited treatment will generally be granted when:

[38] The difference between the July 24 general receipt date for applications awaiting screening and the September 16 inventory date is 54 days.

[39] The difference between the April 19 general receipt date for applications awaiting assignment and the September 16 inventory date is 153 days.

[40] The Agent has ten days to review the case and issue a letter requesting additional information and the applicant has 21 days to respond to this request – a total of 31 days. Adding 31 days to the five months from the received date to the date assigned results in approximately six months. The time between an application's assignment and final determination varies based on several factors, such as the Agent's work load, other application priorities and the need for additional information from the applicant organization. If additional information is needed, the time the organization takes to supply the information also factors in to the time it takes to make a final determination.

[41] TE/GE presentation to the TAS Director of Systemic Business Advocacy, July 30, 2004.

[42] *Id.*

[43] *Id.*

[44] Internal Revenue Manual 7.21.3.4.1 (August 1, 2003) and Internal Revenue Manual 3.45.1.23 (January 1, 2004).

- A grant to the applicant is pending and the failure to secure the grant may have an adverse impact on the organization's ability to continue operations.
- The organization was created to provide disaster relief to victims of emergencies such as flood and hurricane.
- There have been undue delays in issuing a final determination caused by problems within the IRS.
- There is any other situation where the IRS feels expedited treatment is warranted.

Rev. Proc. 2004-4[45] explains:

> Expedite [sic] handling is granted only in rare and unusual cases, both out of fairness to other taxpayers and because the Service seeks to process all requests as expeditiously as possible and to give appropriate deference to normal business exigencies in all cases not involving expedite [sic] handling. . . . Whether the request will be granted is within the Service's discretion. The Service may grant a request when a factor outside a taxpayer's control creates a real business need to obtain a letter ruling or determination letter before a certain time in order to avoid serious business consequences.

Despite this guidance, to receive expedited treatment in practice, "your organization must have a grant pending or must have been promised an asset worth a specific dollar amount."[46] It is not clear why the IRS adopts such a narrow approach to granting expedited treatment.

When an application is granted expedited treatment, it goes to the top of the stack of applications awaiting assignment to a Determination Agent. As of September 15, 2004, only four of the over 11,000 cases in Cincinnati's current inventory awaiting determination had been granted expedited processing.[47]

Several TAS cases dealing with tax-exempt application issues in fiscal year 2004 involved requests for expedited treatment which the IRS denied on the grounds that they did not meet the criteria.[48] TAS stepped in to help these organizations because the delays in processing had created "significant hardships" that met TAS case criteria.[49]

---

[45] Rev. Proc. 2004-4, 2004-1, I.R.B. 125.

[46] Expedited Treatment Denial Letter, February 27, 2001.

[47] IRS Manager Exempt Organization Processing, Handouts, September 15, 2004.

[48] Taxpayer Advocate Management Information System (TAMIS) Business Operating Division (BOD) report quarter ending March 31, 2004 (Sample Size: 87 cases had an MFT 0 (MFT is the coding used on the IRS system to identify the type of tax return filed) and had Taxpayer Advocate issue codes of 160 and 460. Of the 87 cases every fifth case was selected resulting in a population of 19 cases for the review (21.8 percent)).

[49] IRC § 7811(a)(2) defines a significant hardship as (A) an immediate threat of an adverse action; (B) a delay of more than 30 days in resolving taxpayer account problems; (C) the incurring by the taxpayer of significant costs if relief is not granted; or (D) irreparable injury to or a long-term averse impact on the taxpayer if relief is not granted.

TAS cases involving exempt application processing delays include:

- A women's shelter needed tax-exempt status to apply for funding to open a residence (which had been identified and was available). This organization contacted TAS after being denied expedited treatment and being forced to turn away potential residents because the building could not open.
- A girls' softball team could not obtain funding to buy uniforms and equipment without tax-exempt status. The team was to be funded through bingo games and needed exempt status to obtain a state gambling license. The organization contacted TAS after receiving no information about the status of its application from the IRS for nearly five months.
- A dance company faced insolvency because its lack of exempt status restricted funding. The organization contacted TAS 90 days after the IRS received the application and the organization had been unable to obtain any information from the toll-free number on the Acknowledgement Letter. Even after TAS became involved, TE/GE said the application would not be reviewed for 60 to 90 days.
- An organization needed tax-exempt status to seek funding to provide immediate medical care for mentally and physically handicapped children. This organization contacted TAS after the IRS denied its request for expedited treatment, and it had been unable to obtain IRS assistance in providing additional information requested by a Determination Agent.

These examples illustrate how tax-exempt application processing delays can be particularly harmful. Delays in determination mean delays in funding, which smaller organizations may be unable to withstand. When these organizations fold, communities lose the benefits and services the organizations would have provided. And because TE/GE takes such a narrow view in allowing expedited treatment, the organizations in the above examples were denied expedited treatment even after coming to TAS for assistance with hardship situations.

TE/GE is aware of the problem with processing delays. TE/GE's 2004-05 strategic plan notes that the Advisory Committee on Tax Exempt and Government Entities (ACT) recently studied the determination letter process to identify key areas where improvements were possible.[50] The ACT recommended ten changes in May 2003, including facilitating electronic filing of Form 1023, enclosing a "helpful hints" checklist in the Form 1023 application package, taking specific steps to simply portions of the form, and linking the IRS website to state charity officials' sites.[51]

[50] Tax Exempt and Government Entities, *FY 2004-05 Strategy and Program Plan*, 9.

[51] The ACT is an organized public forum the IRS and representatives who deal with Tax Exempt and Government Entities (TE/GE) issues. Members are appointed by the Secretary of the Treasury and serve a two-year term. The ACT allows the IRS to receive regular input on administrative, policy and procedural issues relating to TE/GE customers. IR-2003-129, Nov. 6, 2003; Federal Register, Vol. 68, Number 214, Nov. 5, 2003. The advisory committee's specific recommendations are: (1) Develop a fully interactive Form 1023; (2) Develop a fully e-fileable Form 1023; (2) Facilitate development of a Form 1023 electronic database; (4)

The National Taxpayer Advocate agrees with the ACT's recommendations. To date, however, TE/GE has adopted only a few of the recommended simplification measures. The other recommendations remain in the review and planning stages.[52]

TE/GE is working to adopt the recommendations related to Form 1023 filing and processing. The IRS released a revised Form 1023 on November 1, 2004.[53] One major goal of the revision was to reduce application processing time.[54] The team that developed the revised form included TE/GE Determination Agents and considered comments from organizations such as the American Bar Association.[55]

The new Form 1023 cannot be filed electronically. The IRS does intend, however, to eventually make Form 1023 interactive and to add it to the forms that can be electronically filed. The revised Form 1023 does incorporate certain "interactive" features, including a checklist of items required to be submitted with the application, and presenting certain detailed questions in "yes/no" format to help guide the applicant organization through the Form 1023.[56] The Form 1023 instructions were also rewritten and reorganized in an attempt to be more "clear, user-friendly and intuitive."[57] The IRS website also contains a list of "Frequently Asked Questions about Revised Form 1023."[58] The IRS website also has an interactive application process tool that guides applicant organizations through a step-by-step question and answer session designed to help organizations correctly complete the application.[59]

Although the revised Form 1023 cannot be filed electronically, TE/GE says its ultimate goal is to eventually move to a completely non-paper application process.[60] While this may reduce processing time for some organizations, it will not help those with limited computer or Internet access.

The National Taxpayer Advocate applauds TE/GE's efforts to simplify the application package and its commitment to hearing and incorporating external comments and sugges-

Develop a prominent Form 1023 "Helpful Hints" checklist to include in the Form 1023 application package; (5) Conform the two public support tests in Code section 509(a); (6) Eliminate Form 8734 at the End of Advance Ruling Period; (7) Revise From 1023 to require the applicant to specify the particular Code section 509(a)(3) test under which it intends to qualify and also include the test in the determination letter; (8) Develop a standard public charity reclassification process; (9) Develop a standard "one-stop" name change process; and (10) Link the IRS website to state charity officials' websites. Advisory Committee on Tax Exempt and Government Entities, "Project Aspire," EO Determinations Process Review, May 20, 2003.

52 TE/GE Presentation to TAS Director of Business Advocacy, July 30, 2004.

53 IRS News Release, "IRS Revises Application Form for Charitable Organizations," IR-2004-133 (Nov. 1, 2004).

54 *Frequently Asked Questions about Revised Form 1023*, at http://www.irs.gov/charities/article/0,,id=130101,00.html.

55 IRS Manager Exempt Organization Processing, September 15, 2004.

56 *Frequently Asked Questions about Revised Form 1023*, at http://www.irs.gov/charities/article/0,,id=130101,00.html.

57 *Id.*

58 *Id.*

59 Available at http://www.irs.gov.

60 TE/GE Presentation to the TAS Director of Systemic Business Advocacy, July 30, 2004.

tions. We note, however, that TE/GE did not test the new Package 1023's effectiveness with smaller groups before unveiling it to all applicants, and provided little outreach or education about the new package, particularly to those smaller, community-based organizations and their representatives before its rollout.[61] The National Taxpayer Advocate believes that the revised application's effectiveness could have been enhanced by focused outreach and education efforts.

TE/GE is also attempting to cut application processing time by assigning more experienced Determination Agents to screen the applications. So far, this has increased Merit determinations by nearly 10 percent in FY 2004.[62] However, by assigning more agents to the review process, the number of agents available to assign the remaining determination cases decreases.

A major issue contributing to application processing delays is understaffing. From fiscal years 2001 to 2004, the number of applications has risen from 86,162 to 94,672, yet technical staffing has declined.[63] In fact, TE/GE experienced a nine percent loss in staffing from 2003 to 2004, which is higher than the standard four and one half percent IRS attrition rate.[64] TE/GE staffing was at 191 Determination Agents as of September 15, 2004.

The National Taxpayer Advocate believes that TE/GE could do more to improve tax-exempt application processing time. First, TE/GE should attempt to maintain staffing at a level commensurate with application receipts. Second, TE/GE should undertake research to learn why applications have increased since FY 2001, which could help to project future application receipt numbers. Third, TE/GE should conduct research to determine the number and types of tax-exempt organizations that remain in existence five years after being granted tax-exempt status. This step could help TE/GE tailor its outreach and education efforts to curb both inappropriate applications and common errors in legitimate applications.

B. Tax Complexity and Tax-Exempt Organization Filing Requirements

The current tax-exempt organization filing requirements are unreasonably complex and burdensome, particularly for small organizations. Numerous rules dictate which forms a particular tax-exempt group must file. If an organization does not file the proper forms accurately and timely, it will be assessed penalties and may even risk losing its tax-exempt status. Depending on its particular circumstances, an entity may be exempt from filing or be required to file at least one of four different annual information returns:

[61] Draft Package 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, Catalog Number 17132z (Rev. Aug. 16 2004).

[62] IRS Manager, Exempt Organization Processing, September 15, 2004. The remaining applications are then shelved awaiting assignment. There is no corresponding increase or decrease in rejections, for this percentage of applications the determination are made sooner.

[63] IRS Manager, Exempt Organization Processing, September 15, 2004.

[64] Determination Groups – Staffing /Receipts, Directory Exempt Organization Processing, September 15, 2004

Exempt from filing - If the tax-exempt organization is a church or the amount of gross receipts of the organization is less than $ 25,000, it does not need to file the Form 990 or 990EZ. However, it may be required to file a Form 990-T if it has unrelated business income or a specific form to report an information item that is required by the law.[65]

Form 990-EZ – An organization can file Form 990-EZ if it has over $25,000 in gross receipts but total income does not exceed $100,000, and gross assets at the end of the year are less than $250,000. Form 990-EZ has two pages and 43 lines to complete.[66] Estimated time to prepare and complete the form is 55 hours and 39 minutes, or nearly seven days.[67] All organizations filing Forms 990-EZ or 990, must complete both Schedules A and B as well.

While a small tax-exempt organization may meet the gross income threshold, it may exceed the year-end asset threshold if it owns appreciated assets, such as real estate. The Taxpayer Advocacy Panel (TAP) has suggested that the gross receipts requirement be adjusted to allow more small exempt organizations to file a Form 990-EZ.[68] Increasing the gross assets requirement would also allow more small tax-exempt entities to file a Form 990-EZ.

Form 990 – Tax-exempt organizations not eligible to file Form 990-EZ are required to file Form 990.[69] This form has six pages and 105 lines. The Form 990 instruction booklet has 46 pages of instructions.[70] Estimated time to prepare and complete the form, including Schedules A and B, is 213 hours and 56 minutes or approximately 26 days.[71] The $100,000 gross receipts and $250,000 gross assets threshold amounts are not adjusted for inflation, so it is likely that more and more tax-exempt organizations will be required to file the longer Form 990. About 20 percent of the tax-exempt entities filing Form 990 in 2003 reported income of less than $25,000 and about 50 percent of these entities reported income of less than $100,000.[72] While an annual adjustment for inflation would be impractical, there is merit to considering a periodic adjustment to the gross income thresholds.

[65] Form 990-T, *Exempt Organization Business Income Tax Return*, Cat. No.11292J (2003). Unrelated Business Income is taxable and is defined as "income from a trade or business that is regularly carried on by an exempt organization and that is not substantially related to the performance by the organization of its exempt purpose or function except that the organization uses the profits derived from this activity." Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, Cat. No. 46598X (Rev. March 2000). Although the organization is tax-exempt, it is subject to the information reporting requirements of IRC § 6033.

[66] Form 990-EZ, Short Form Return of Organization Exempt from Income Tax, Cat. No. 106421I (2004).

[67] Assuming eight hour work days. Instructions for Form 990 and Form 990-EZ, Cat. No. 22386X (2003), 44

[68] Taxpayer Advocacy Panel, *Recommendations for Form 990*, TAP 03-013 (September 12, 2003). The TAP recommendations included eight specific changes to Form 990, most of which dealt with simplification in an effort to reduce penalties and related issues. The Taxpayer Advocacy Panel is a group of private citizen volunteers who are appointed by the Secretary of the Treasury and work under the direction of the National Taxpayer Advocate to advise the IRS on problem areas and customer service.

[69] *i.e.*, organizations with more than $100,000 in annual gross receipts or more than $250,000 in gross assets at year end. Form 990, Return of Organization Exempt from Income Tax, Cat. No. 11282Y (2004).

[70] Instructions for Form 990 and Form 990 EZ, Return of Organization Exempt from Income Tax and Short Form Return of Organization Exempt from Income Tax Under Section 501(c), 527, or 4947(a)(1) of the Internal Revenue Code (except black lung benefit trust or private foundations), Cat. No. 22386X (2003).

[71] Assuming an eight hour work day. Instructions for Form 990 and Form 990-EZ, Cat. No. 22386X (2003), 44.

[72] SOI strata of asset and income data for Form 990 filers for 2003 (tax periods 200301 through 200312). Please note that Form 990 entities with gross receipts less than $25,000 and churches are generally not required to file Form 990.

The Taxpayer Advocacy Panel made the following seven specific recommendations to simplify Form 990 in September 2003: (1) include a plain language pamphlet to assist smaller and newer non-profits; (2) provide filing assistance and information through the IRS toll free number, IRS website and workshops to be marketed more broadly; (3) develop a web-based tutorial about completing Form 990; (4) provide a training video or CD to assist in completing the Form 990; (5) develop a communication strategy that includes key messages for the Form 990; (6) market the Form 990-EZ; and (7) adopt a "good faith" standard in applying the daily delinquency penalty and incorporate that standard into the reasonable cause definition.[73]

The IRS has indicated that it will work to adopt many of the TAP's recommendations, including developing plain language pamphlets, studying the feasibility of tutorials, increasing filing season communications on Form 990 issues, and considering changes to daily delinquency penalty assessments.[74]

Schedules A and B - Schedules A and B are required with Form 990 or Form 990-EZ. IRC section 501(c)(3) organizations and IRC section 4947(a)(1) trusts are required to file Schedule A to report additional information not required of other types of tax-exempt organizations.[75] The Schedule A instructions are 14 pages long. The error rate for Schedule A on Form 990 EZ is 33 percent.[76]

All organizations filing Forms 990, 990-EZ or 990-PF must file Schedule B to report contributor information.[77] The error rate for Schedule B ranges from 34 percent for Form 990-T to 70 percent for Form 990.[78]

Form 990-T - A tax-exempt organization may also be required to file Form 990-T, Exempt Organization Business Income Tax Return.[79] This form is required if the organization has income from unrelated business activities of $1,000 or more.[80] This form is four pages long with 49 lines, five parts, and ten schedules. The instructions for this form are 20 pages long. The estimated time to prepare and complete Form 990-T is 138 hours, or more than 17 days.[81]

[73] Taxpayer Advocacy Panel, *Recommendations for Form 990*, TAP 03-013 (September 12, 2003).

[74] IRS Director, Exempt Organizations, *RE: Recommendations for Form 990* TAP 03-013 (November 10, 2003).

[75] Schedule A, Organization Exempt Under Section 501(c)(3), Cat. No. 11285F (2004).

[76] Memorandum for Director, Exempt Organization SE:T:EO, *EO Correspondence Review and Timeframes* (October 2003).

[77] Instructions for Form 990 and Form 990-EZ, Cat. No. 22386X (2003), 3.

[78] Memorandum for Director, Exempt Organization SE:T:EO, *EO Correspondence Review and Timeframes* (October 2003).

[79] Form 990-T, *Exempt Organization Business Income Tax Return*, Cat. No.11291J (2003).

[80] *See* Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, Cat. No. 46598X (Rev. March 2000).

[81] Assuming eight hour work days. Instructions for Form 990-T, *Exempt Organization Business Income Tax Return*, Cat No. 11292U, (2003), 19.

Form 1120-POL – Political organizations, or other organizations that have political organization taxable income are required to file Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations. These organizations must file this form regardless of whether they are tax-exempt.[82]

According to TE/GE's 2004-05 strategic plan, in 2004, exempt organizations will be able to file Forms 990, 990-EZ, 1120-POL and 8868 electronically through the IRS Modernized e-File (MeF) system. In 2005, the IRS plans to deploy electronic filing capabilities for Form 990-PF. The IRS hopes that these steps, once implemented, will reduce the burden on tax-exempt organizations by catching errors that would otherwise result in a return being rejected, and reduce labor-intensive manual processing.[83]

Outreach and Education

TE/GE's Exempt Organizations (EO) business unit ensures that religious, charitable, social, educational, political and other not-for-profit organizations meet and maintain compliance with the complex requirements for tax-exempt status. As stated earlier, this customer base in tax year 2003 consisted of over 1.6 million organizations.[84] In 2003, more than 789,381 tax-exempt organizations filed an annual return.[85] In FY 2004, over 92,000 organizations requested a determination of their tax-exempt status.[86] These numbers demonstrate the great need to provide outreach and education to the tax-exempt organization population.

EO's Customer, Education & Outreach (CE&O) office hosts Exempt Organization full-day workshops in major cities each year. In FY 2004, these workshops focused on Internal Revenue Code Section 501(c)(3) organizations. The workshops were held in Atlanta, Baltimore, Boston, Chicago, Denver, and San Diego. Invitations to the workshops were sent to preparer groups and organizations that had recently received tax-exempt status and that were located near the cities where the workshops were offered. Information about these workshops was also posted on the IRS website. Because of the workshops' high attendance, in FY 2003 the workshop seating capacity was increased from 75 to 150.

EO CE&O also provides workshops and seminars during the annual IRS Tax Forums. These three-hour workshops address many of the same topics covered in the full-day workshops, including a seminar on the Form 990. All of these workshops and seminars have been well attended, usually reaching maximum seating capacity. The evaluations

[82] Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations*, Cat. No. 11523K (2004).

[83] *Tax Exempt and Government Entities, FY 2004-05 Strategy and Program Plan*, 10.

[84] Available at http://www.irs.gov/pub/irs-soi/03db19ep.xls. *Tax-Exempt Organizations and Other Entities Listed on the Exempt Organization Business Master File, by Type of Organization and Internal Revenue Code Section, Fiscal Years 2000-2003, IRS SOI Table 22*, last viewed on August 17, 2004.

[85] Available at http://www.irs.gov. 2003 Data Book, Table 3. Note that this number does not include churches and organizations with income of less than $25,000, which are not required to file an annual return.

[86] Manager Exempt Organizations Determinations, Handout, September 15, 2004.

done at the end of each workshop or seminar are used to re-evaluate and re-design the presentations for future years. EO has not yet produced a video tape of the workshop but does offer a workbook, which can be ordered through the IRS publishing office.[87] This 11-chapter booklet includes information on applying for tax-exempt status, keeping tax-exempt status, defining unrelated business income, and filing obligations.

In FY 2004, EO initiated its first partnership event with the California Attorney General's office in an attempt to educate organizations that may apply for tax-exempt status. The focus on this meeting was to provide information about the application for recognition of tax-exempt status. [88] The presentation covered the top 10 reasons for delays in processing the application for tax-exempt status, filing requirements, certain issues regarding gaming income, employment issues, record keeping, the audit process, and required disclosures.[89]

While the method of measuring an outreach effort reflects only the number of customers reached, EO has done a good job in providing meaningful education and outreach to its customers. Each year EO has broadened and improved its efforts in addressing common errors and concerns. EO uses trends identified through return processing and customer surveys as well as feedback from an outside panel to continually improve its educational efforts. And by reviewing and planning for events, EO can make these improvements without a significant increase in staffing dedicated to these functions.

The National Taxpayer Advocate believes that EO has a strong outreach and education program, but also sees room for improvement. EO's outreach and education efforts could be improved generally by implementing measures to tailor outreach and education to specific segments of the tax-exempt organization population. There does not appear to be a current program aimed at understanding and analyzing the increasing number of exempt organizations. There also appears to be no system in place to measure the actual effectiveness of current outreach and education efforts (beyond merely measuring numbers of customers reached), or the effect these efforts have on compliance. The National Taxpayer Advocate believes that implementing effective measurement and research programs could make EO's outreach and education program even stronger. The National Taxpayer Advocate also believes that CE&O could increase the effectiveness of its Exempt Organization workshops by expanding their reach beyond major cities, and using demographic information to select workshop locations where significant pockets of tax-exempt organizations are located.[90]

[87] IRS, *Exempt Organizations Participant Text*; Training 4325-002 (Rev. 2-2004), Cat. No. 88908P.

[88] Interview with Director of Customer Education and Outreach on July 30, 2004; *Application for Recognition of Exemption Under Sec. 501(c)(3) of the Internal Revenue Code*, Package 1023, and *Application for Recognition of Exemption Under Section 501 (a)*, Package 1024, which are used for the application of tax-exempt status.

[89] Interview with Director of Customer Education and Outreach on July 30, 2004.

[90] For example, demographic information from 2001-2003 shows that there were large increases in tax-exempt organization returns filed in New Jersey, California and North Carolina. IRS, *Number of Returns Filed, by Type of Return and State, FY 2003, Table 3,* March 2004. A workshop was held in San Diego in 2004, but no workshops were held in North Carolina or the New Jersey area.

IRS COMMENTS

The Exempt Organization Division (EO) must balance its examination presence with its determination workload. Previously, the EO redirected many of its examination staff to the Determinations Office in order to handle the growth of applications for exemption. However, in an environment of little or no growth in hiring, this action resulted in a decline in examination coverage and permitted the proliferation of abuses in the exempt organization community. Therefore, one of the IRS's key strategic priorities is to reduce the abuses with exempt organizations. Thus, in support of this strategic priority, the EO stopped the practice of transferring examination staff to determinations.

Application for tax-exempt status

Form 1023

As the TAS report indicates, the IRS announced a new Form 1023, Application for Exemption, in October 2004. The form was produced as a result of the EO's Customer Satisfaction Team which was charged with revising the old form in light of customer experience and compliance concerns. The team not only consulted with many internal "customers', *i.e.* Toll Free operators who hear organization's concerns, but with numerous outside stakeholders. Initially, the IRS solicited comments on the original proposed draft through Announcement 2002-103, 2002-45 I.R.B. 838, as well as posting it on the Internet. The IRS received 25 formal responses from professional groups and individuals. The EO also worked very closely with its advisory group, the Advisory Committee on Tax Exempt and Government Entities (ACT), which specifically was asked to address concerns about small volunteer applicants.

The universal response regarding smaller organizations was that although the form was longer than the old one, the new form provided clearer instructions as well as providing educational information to a new organization about the requirements of Federal tax-exempt law. Further, typically, smaller organizations are not required to complete the entire application.

Finally, the IRS believes that the new form will also provide greater information about the growing population of exempt organizations that will help promote voluntary compliance through reducing abuses and by allowing more targeted outreach efforts. The IRS will continue to work toward a web-based application featuring interactive tools to help organizations complete the form and will continue education efforts to aid taxpayers with the form.

Delays

The IRS concurs that the determination process needs improvement in order to provide better service to organizations. The IRS has already begun making interim process changes which have produced positive results. Through various design improvements, the number of applications awaiting screening has been reduced by approximately 40 percent during November 2004. In addition, the time waiting to be screened has been reduced from over 60 days to within 30 days of the control date. Other changes have had similar results and the IRS expects to make further changes in the near term.

The IRS is also planning to hire an additional 20 employees to help with the screening efforts to reduce the backlog. Longer term process changes will be recommended within the next several months that we believe will reduce the delays in the system.

The IRS also recognizes that the expedite process has certain limitations; however, the IRS does not agree that every request should be expedited which might result in inequities in the system or everyone being moved to the front. The IRS is reviewing the process and hopes to make changes that will improve the process.

Form 990

The IRS is cognizant of the existing complexity of the Form 990 as well as the fact that it does not provide the EO with sufficient information to aid in its compliance efforts. As a result, the IRS is taking the following steps:

- A team is working on revising the Form 990 and related schedules, but as with the Form 1023, the desire for simplicity must be balanced with the need for concrete enforcement information;
- The IRS has received numerous comments from internal and external stakeholders who are aware of the efforts to revise Form 990 and formal comments will be solicited when the form is in the final development stage; and,
- As indicated in the TAS report, the IRS has successfully implemented electronic filing capabilities for Forms 990, 990 EZ, 1120 POL and 8868, and will do so with the 990 PF this coming filing season. The IRS believes that electronic filing is the key to ease many taxpayer burdens as well as assist us with our compliance efforts.

Outreach and education

The IRS appreciates the positive remarks concerning the CE&O Program. The IRS notes that expansion of the program with the current budget will be difficult. Nevertheless, the plan is to be more efficient in our outreach methods by reaching more customers through automated efforts such as the Internet, videos, or other mass media outlets.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate recognizes EO's Determination Office staffing limitations and appreciates EO's efforts to balance its examination and determination responsibilities with limited staff. In fact, as the Annual Report to Congress was developed, TAS was impressed with the Determination Office's efforts to process its application receipt volume with its current staff, and is glad to hear of the plans to increase this staff. The National Taxpayer Advocate believes, however, that EO could take steps to improve determination processing time despite its limited resources, particularly when the existence of small tax-exempt organizations is at stake. The lack of IRS resources should not be used as justification for a lack of response.

The National Taxpayer Advocate recommends that the IRS do more to communicate with organizations applying for tax-exempt status when there are delays in the determination process. Specifically, we recommend that the IRS notify applicants by letter in cases where the determination process will take longer than the 120 days specified in the Acknowledgement Letter.

The National Taxpayer Advocate recommends that TE/GE employ a better measurement system to capture the amount of time it takes for an application to be screened and processed, and for the final determination to be made. Specifically, the National Taxpayer Advocate recommends that TE/GE discontinue the practice of blending Merit and non-Merit determination processing times and begin to monitor them separately. These two types of determinations are fundamentally different, with non-Merit determinations requiring much more time and resources than Merit determinations. When Merit and non-Merit measures are mixed, processing times for non-Merit determinations are artificially reduced. This approach makes it difficult, if not impossible, to allocate Determination Office resources allocation efficiently. Non-blended measures will result in more accurate processing time numbers, which will promote better resource allocation, and ultimately, faster processing times.

The National Taxpayer Advocate does not believe, as the IRS response suggests, that every case that might result in inequities be allowed expedited treatment. We are concerned primarily with small organizations that would experience a significant hardship due to processing delays. With respect to requests for expedited treatment, the National Taxpayer Advocate recommends simply that EO more closely follow the policies set forth in the IRM and Rev. Proc. 2004-4, rather than the "pending grant" or "promise of an asset worth a specific dollar amount" standards that EO seems to be using currently.

The National Taxpayer Advocate commends TE/GE for its work in simplifying Form 1023 and its plans to revise Form 990. We also believe that TE/GE's goals of working to eventually facilitate electronic filing for these and other applicable forms, and to make these forms more interactive have great merit. In pursuing this goal, however, the National Taxpayer Advocate hopes that TE/GE will remain mindful of the needs of organizations with limited, or no, computer access.

The National Taxpayer Advocate also commends EO for its outreach and education efforts and its stated plans to reach more organizations through various electronic media. The National Taxpayer Advocate also believes, however, that these efforts could be better targeted to specific segments of the tax-exempt population and enhanced for small and newly formed tax-exempt organizations.

PROBLEM

TOPIC D-14 MOST SERIOUS PROBLEM: IRS EXAMINATION STRATEGY

RESPONSIBLE OFFICIAL

Mark E. Matthews, Deputy Commissioner for Services and Enforcement

DEFINITION OF PROBLEM

Significance of the Tax Gap

The difference between the Federal income tax due each year and the amount voluntarily and timely paid, known as the "tax gap," is a significant problem. Individuals and businesses that evade their tax obligations impose a heavy burden on those who comply. The IRS estimates that the annual net tax gap (*i.e.*, the gross tax gap reduced by the taxes eventually collected) is about $255 billion.[1] Dividing this gap by the 130 million individual taxpayers shows that, on average, each individual pays almost $2,000 in taxes each year to subsidize those who do not pay their share.[2]

IRS Tax Gap Reduction Plan

The IRS intends to reduce the tax gap through increased enforcement.[3] However, its new examination initiatives are not specifically focused on underreporting by small business and self-employed taxpayers,[4] which the IRS has identified as the largest component of the gap.[5]

Lack of Actionable Information

The IRS does not have sufficient information and research to determine how best to allocate its resources, including examination resources, to achieve its tax-gap-reduction goal. New data from the National Research Program (NRP) regarding taxpayer compliance will soon be available.[6] However, if the IRS is to achieve more than incremental reduction of the tax gap, it needs actionable information not just about which taxpayers are not complying, but also about the causes of non-compliance so that limited resources can be used most effectively.

1 *See* IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (Feb. 24, 2004).

2 IRS, *Statistics of Income, Winter 2003-2004 Bulletin*, Publication 1136 (Rev. 2-2004) (Table 22). The term "taxpayers" refers to the number of returns filed, including joint returns.

3 *See generally*, IRS, *Strategic Plan 2005-2009*, Publication 3744 (Rev. 6-2004) (indicating a major objective to "discourage and deter non-compliance with emphasis on corrosive activity by corporations, high-income individual taxpayers and other contributors to the tax gap"). *See also* IRS, *FY 2005 Budget Request*, Document 9940 (Rev. 2-2004).

4 *See* Senate Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 TNT 145-30 (July 21, 2004). *See also* IRS, *Strategic Plan 2005-2009*, Publication 3744 (Rev. 6-2004) at 9. Of course the Small Business/ Self-Employed (SB/SE) division does have compliance initiatives. *See* SB/SE Strategy and Program Plan FY 2004-2005 (Rev. 3-31-2004) at 8 (discussing SB/SE compliance initiatives).

5 *See* IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (Feb. 24, 2004).

6 *See Bridging the Tax Gap: Hearing Before the Senate Committee on Finance*, 108th Cong., 2nd Sess. (July 21, 2004) (Statement of Mark W. Everson, Commissioner of Internal Revenue).

The IRS also needs more detailed information about the "direct" and "indirect" revenue effects of its examinations. The direct effect is the amount eventually collected as a result of the examination.[7] The indirect effect is the increase in voluntary compliance in the population at large resulting from the examination (called the "ripple effect") and the increase in voluntary compliance of the examined taxpayer in subsequent years (called the "subsequent year effect").[8] For example, as word spreads that the IRS is examining commercial fisherman in Maine, the voluntary compliance of that group may increase.

Economists have estimated the indirect effect of an examination on voluntary compliance to be between six and 12 times the amount of the proposed adjustment.[9] However, the IRS has not systematically considered the indirect effect of examinations on compliance when selecting returns for examination.[10] Because the IRS will never have the resources to collect taxes from every noncompliant taxpayer, detailed information about the indirect effect of each examination (*e.g.*, estimates that take into account the type and accuracy of the examination, taxpayer characteristics, and geographic region) will be critical if examination tools are to produce more than incremental improvements in the tax gap. In short, the IRS needs better information about whether it is focusing on the right taxpayers and the right issues, and using the right approach to maximize compliance by each taxpayer population.

ANALYSIS OF PROBLEM

Historical Background – *Compliance 2000*

More than a decade ago the IRS recognized that research could be used to allocate limited resources to improve voluntary compliance more effectively when it formed a strategy called *Compliance 2000* and created District Compliance Planning Councils.[11] *Compliance 2000* was a proactive, research-based compliance strategy that the IRS pursued in the late 1980s and early 1990s with the goal of increasing overall compliance (using both enforcement and nonenforcement tools) to 90 percent by 2001.[12] It called for the IRS to foster voluntary compliance by addressing the root causes of noncompliance for discrete taxpayer segments[13] and then providing the most efficient response, such as taxpayer education,

[7] Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96), Washington, DC, 2.

[8] *Id.*

[9] *Id.* at 35-36; Jeffrey A. Dubin, Michael J. Graetz and Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax*, 1977-1986, 43 NAT. TAX J., 395, 396, 405 (1990).

[10] *See* Alan Plumley and Eugene Steuerle, *An Historical Look at the Mission of the Internal Revenue Service: What is the Balance between Revenue and Service? The Crisis in Tax Administration*, November 2002, 15-16. *See also*, Internal Revenue Service, *Evaluation of the IRS System of Projecting Enforcement Revenue*, Publication 1501 (11-89) Washington, DC, 5; SB/SE Examination Priorities Presentation, April 22, 2003, 12-14; General Accounting Office, *Tax Administration, IRS' Return Selection Process*, GAO/GGD-99-30 (Feb. 1999).

[11] General Accounting Office, *IRS Has Made Progress but Major Challenges Remain*, GAO/GGD-96-109, 2-9 (June 1996).

[12] *Id.*

tax form simplification, outreach, or enforcement.[14] The goal of this approach was to increase voluntary compliance by the most effective means rather than merely to focus on direct examination results.[15] Thus, it implicitly acknowledged that examinations are one of many activities that indirectly affect tax compliance.

The first step in developing a compliance initiative under *Compliance 2000* was to identify pockets of noncompliance, such as drywall contractors in a particular city.[16] Research would then determine the reason for noncompliance, and an appropriate response (either enforcement or nonenforcement) would be tested and initiated.[17]

Beginning in the mid-1990s, *Compliance 2000* spurred the formation of Compliance Planning Councils to oversee regional compliance programs.[18] The Compliance Planning Council allowed District Directors to "opt out" of nationally mandated market-segment-based examination work when it could be demonstrated that compliance was within tolerance levels.[19] This allowed the regional compliance programs to focus on local non-compliance issues and address them with the most appropriate tool.

The *Compliance 2000* approach required significant research to identify national and regional pockets of noncompliance and determine its causes.[20] The IRS anticipated that the primary research tool would be the Compliance Research Information System (CRIS), a network of databases containing sample data spanning multiple years.[21]

Compliance 2000, however, did not survive.[22] In October 1995, the Tax Compliance Measurement Program (TCMP) was indefinitely postponed due to budget constraints and

[13] Those discrete segments, called "market segments," are groups of taxpayers with common characteristics and tax situations. Examples of types of market segmentation are: Like-kind businesses and industries, types of returns, employment status, cultural background, and common tax issues. IRS, *Compliance 2000 Orientation Guide*, Document 9102 (07-1993), 16, 49. One of the goals of market segmentation was to better focus the use of enforcement resources; another was to ensure consistency across taxpayer groups. *Id*. at 50.

[14] *See generally*, *IRS Strategic Business Plan FY1992 and Beyond*, IRS Document 7382 (Sept. 1991); IRS, *Compliance 2000: Orientation Guide*, Document 9102 (Rev. 7-1993).

[15] *Id*.

[16] General Accounting Office, *IRS Has Made Progress but Major Challenges Remain*, GAO/GGD-96-109, 3 (June 1996).

[17] *Id*. at 10, 27.

[18] *Id*. at 9, 30.

[19] *See* IRS, District Office of Research and Analysis (DORA), *Phase I Training Material: IV. Framework; NORA, DORA roles*, 8. Prior to reorganization in 1998, the IRS was organized into a three-tier geographic structure with a National Office, Regional Offices and District Offices. There were four regions and 33 districts. District Directors were in charge of overseeing all IRS functions within their district. See S. Rep. No. 105-174 at 9 (1998).

[20] This approach utilized the National Office of Research and Analysis (NORA) and the District Offices of research and Analysis (DORA), which were national and local IRS research offices, respectively. General Accounting Office, *IRS Has Made Progress but Major Challenges Remain*, GAO/GGD-96-109, 2 (June 1996).

[21] *Id*. at 2, 7-8.

[22] *See, e.g.*, IRM 5.1.11.12 (Rev. 5-27-1999); IRM 4.19.1.1.5.4 (Rev. 10-1-2001); IRM 21.8.1.1.3.4 (Rev. 12-1-2000).

controversy.[23] Because CRIS relied on 1988 TCMP data that would become less useful as time passed, the IRS did not have objective compliance data that it needed to effectively implement *Compliance 2000*.[24]

In 1996 the General Accounting Office (GAO, now the Government Accountability Office) found that *Compliance 2000* had "generated few compliance gains" and blamed tensions between national and district research priorities, a lack of objective data, and the absence of an infrastructure for planning, managing and monitoring research projects.[25] *Compliance 2000* was thus abandoned because of difficulties in implementation, not because its research-based approach was not sound.[26]

Examinations and the Tax Gap

While the IRS has historically recognized that examinations are not the only effective tool for addressing the tax gap,[27] they are an important part of its current tax gap reduction strategy.[28] Eighty percent of the gross tax gap ($249 billion of $311 billion) is attributable to underreporting tax liabilities.[29] Examination is one of the compliance tools that the IRS uses to detect and deter underreporting.[30]

Declining Examination Rates, Decline in Face-to-Face Exams

With the exception of an increase in the early 1990s, examination personnel and coverage rates (i.e., the number of examinations per tax return) have been declining since the late 1970s.[31] Recent data suggests that the decline in audit coverage rates is leveling off, due in large part to the IRS' increasing use of correspondence examinations,[32] which are conduct-

[23] General Accounting Office, *IRS Has Made Progress but Major Challenges Remain*, GAO/GGD-96-109, 2, 7-8 (June 1996).

[24] *Id.* at 4.

[25] *Id* at 27.

[26] The *Compliance 2000* initiatives were consolidated into the Compliance Initiative Projects (CIP) in 1997. IRM 5.1.11.12 (Rev. 5-27-1999); IRM 4.19.1.1.5.4 (Rev. 10-1-2001); IRM 21.8.1.1.3.4 (Rev. 12-1-2000). CIPs are typically local activities involving contact with specific groups of taxpayers. IRM 4.17.1 (Rev. 2-1-2004) through IRM 4.17.4 (Rev. 2-1-2004). However, before a CIP may be initiated it must be formally approved at the national level. *Id.*

[27] *See* Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-1996), 40-41 (estimating that IRS tax preparation efforts were the second most cost effective activity that the IRS could undertake to increase voluntary compliance).

[28] *See* IRS, *Strategic Plan 2005-2009*, Publication 3744, 19 (Rev. 6-2004).

[29] *See* IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (Feb. 24, 2004).

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

[31] *See* Alan Plumley and Eugene Steuerle, *An Historical Look at the Mission of the Internal Revenue Service: What is the Balance between Revenue and Service?, The Crisis in Tax Administration*, 7-9 (Nov. 2002).

[32] *See generally*, Treasury Inspector General Tax Administration, *Trends in Compliance Activities Through Fiscal Year 2003*, Reference No. 2004-30-083, 8 (April 2004). Correspondence exams accounted for 81 percent of the examinations of individuals with incomes under $100,000 and 52 percent of the examinations of individuals with incomes $100,000 and over in FY 2003. *Id.* at 8.

ed by mail and generally address fewer issues than face-to-face examinations.[33] The shift from broad face-to-face examinations to narrow correspondence examinations is an effort, in part, to prevent further erosion in audit coverage rates, since IRS staffing is expected to decline even under the current budget proposal.[34] Thus, this shift appears to be driven more by costs (and perceived audit coverage requirements) than by a research-based cost-benefit analysis that takes into account the indirect effect of voluntary compliance that it may produce.

The overall effect on compliance of substituting correspondence examinations for face-to-face examinations should be studied.[35] It is possible that a narrow correspondence audit that does not detect significant noncompliance may actually have a relatively smaller indirect effect on compliance than a broad face-to-face examination as taxpayers get the message that in the unlikely event they are audited, it is even more unlikely that noncompliance will be detected.[36] Further, the relative indirect effects of correspondence examinations are likely to vary by taxpayer segment and community. The IRS needs more research on the relative indirect effects of correspondence and face-to-face examinations on voluntary compliance to make informed decisions consistent with tax gap reduction goals.

Goal of Audit Selection Process is Not Tax Gap Reduction

The IRS uses over 40 methods of selecting returns for examination.[37] However, one of the most frequently used selection tools is the Discriminant Function (DIF) System.[38] Under this system, tax returns are computer scored and assigned a numeric value (a "DIF score") based on the potential for an examination to change the tax liability.[39] Returns with the highest DIF scores are then reviewed by an examination official who decides if the returns

[33] *See generally*, General Accounting Office, I*RS Audits, Weaknesses in Selecting and Conducting Correspondence Audits*, GAO/GGD-99-48 (March 1999).

[34] IRS Oversight Board, *FY2005 Budget/Special Report*, March 2004, 11-12.

[35] The IRS has normatively evaluated the indirect effect of various types of examination and non-examination activities. *See* Alan H. Plumley, *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results*, National Tax Association 95th Annual Conference on Taxation (Nov. 2002), 11-14.

[36] *See generally*, Karyl A. Kinsey, *Deterrence and Alienation Effects of IRS Enforcement: An Analysis of Survey Data*, Why People Pay Taxes, 259, 276 (Joel Slemrod ed., 1992); American Bar Association Commission on Taxpayer Compliance, *Report and Recommendations on Taxpayer Compliance*, 41 Tax Law. 329, 364-365 (1988) (suggesting that low quality audits may be as bad or worse for compliance than no audit at all). As an audit get more focused, it also becomes more important to know the relative indirect effect of the audit based upon the issues selected for examination.

[37] *See* General Accounting Office, *Tax Administration: IRS' Use of Random Selection in Choosing Returns for Audit*, GAO/GGD-98-40, 2 (February 1998).

[38] In the early 1990's, roughly 59 percent of all returns selected for audit were selected by DIF. General Accounting Office, *Tax Administration, IRS Return Selection Process*, GAO/GGD-99-30, 2 (Feb. 1999). A variation of DIF is designed to select returns with unreported income (the UI-DIF). *See* Internal Revenue Service, *Weekly Report to the Secretary*, "IRS Develops Tool to Find Unreported Income" (Sept. 10, 2002), 1.

[39] IRM 4.1.3.1 (Rev. 5-19-1999).

should be audited and what items and issues should be examined.[40] The DIF score does not necessarily have any relation to the total revenue the examination is likely to generate.

Direct Revenue Collection Not Considered

The goal of each return selection process has typically been to select returns for audit that will result in the greatest recommended change.[41] However, the IRS has rarely considered whether the dollars assessed have the potential to be collected.[42] This suggests that the IRS examination strategy may not have been maximizing *direct* revenue recovery.

Indirect Revenue Collection Not Fully Considered

More importantly, the greater *indirect* effect that an examination may have on compliance has not been systematically considered in selecting specific returns or items for audit.[43] Some examinations yield little direct revenue, but have a large ripple effect on the compliance of other taxpayers.[44] The IRS has traditionally addressed indirect effects (such as deterrence) simply by examining some minimum number of returns in each taxpayer category, rather than focusing on specific returns or issues likely to produce the greatest indirect effects.[45]

In its most recent strategic plan, the IRS proposes to discourage and deter noncompliance by refining its return selection criteria to target returns that significantly underreport their income, and by hiring additional personnel to focus on high-income and corporate cases.[46] An examination strategy focused primarily on significant underreporting of

[40] *See* IRM 4.1.3.1 (Rev. 5-19-1999).

[41] *See* Alan Plumley and Eugene Steuerle, *An Historical Look at the Mission of the Internal Revenue Service: What is the Balance between Revenue and Service? The Crisis in Tax Administration* (Nov. 2002) 15-16. *See also*, Internal Revenue Service, *Evaluation of the IRS System of Projecting Enforcement Revenue*, Publication 1501 (Rev. 11-89) Washington, DC, 5; Treasury Inspector General for Tax Administration, *More Information Is Needed to Determine the Effect of the Discretionary Examination Program on Improving Service to All*, Reference No. 2003-40-185, 13 (August 27, 2003) (IRS response); SB/SE Examination Priorities Presentation, April 22, 2003. However, the current IRM suggests that returns not selected by DIF scores may be selected to achieve voluntary compliance by an identifiable group of taxpayers. IRM 4.19.1.2.3 (Rev. 10-1-2001).

[42] *See, e.g.*, Alan Plumley and Eugene Steuerle, *An Historical Look at the Mission of the Internal Revenue Service: What is the Balance between Revenue and Service? The Crisis in Tax Administration* (Nov. 2002), 15-16.

[43] General Accounting Office, *IRS Measures Could Provide A More Balanced Picture of Audit Results and Costs*, GAO/GGD-98-128 (June 1998); Internal Revenue Service, Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates (Supplement to Publication 7285), Publication 1415 (Rev. 4-90) Washington, DC.

[44] In the context of tax credit programs, such as EITC, an audit might have the effect of discouraging taxpayers from claiming the credit even in cases where they were eligible. Since the government intends eligible taxpayers to have the credit this might be thought of as a negative indirect effect.

[45] *See* Alan Plumley and Eugene Steuerle, *An Historical Look at the Mission of the Internal Revenue Service: What is the Balance between Revenue and Service? The Crisis in Tax Administration* (Nov. 2002), 15-16. *See also*, Internal Revenue Service, *Evaluation of the IRS System of Projecting Enforcement Revenue*, Publication 1501 (Rev. 11-89) Washington, DC, 5.

[46] *See* IRS, *Strategic Plan 2005-2009*, Publication 3744 (Rev. 6-2004), 19. In recent years, IRS resources have also been disproportionately allocated to examinations and other enforcement activities targeting low income taxpayers, such as those claiming the Earned Income Tax Credit (EITC). *See* Treasury Inspector General for Tax

income by high-income individuals and corporations may, in fact, significantly reduce the tax gap by reason of an indirect effect. However, the IRS has not projected the relative indirect effect of examining such returns to determine whether such a strategy is likely to be the most efficient use of resources in reducing the tax gap.

Indirect Effect of Publicity

Researchers have suggested that publicizing the tax gap may increase the perception that other taxpayers are dishonest, thereby reducing compliance.[47] The publicity surrounding the IRS' need to examine high income individuals and corporations may increase the visibility of unpunished (or lightly punished) tax cheating rather than reinforce the public's belief that all taxpayers are paying their fair share. Thus, it is unclear whether the indirect effect of increased examinations of high income individuals and corporations will be positive or negative.

Indirect Effect by Taxpayer Segment

Moreover, it is possible that the indirect effects of examining high income individuals and corporations may vary by taxpayer segment. For example, will taxpayers with cash businesses be unaffected because they are confident that they will not be recognized as having a high income? Will wage earners with high incomes forego legitimate deductions for fear of audit or will they ignore the initiative because they do not think of themselves as high income? One study found that high income taxpayers did not increase compliance in response to audit threats, perhaps because they viewed an audit as a negotiation and they wanted to start negotiating from a low number.[48] The indirect effect may also vary by location. Are taxpayers in New York City more likely to change their compliance behavior as a result of increased examinations of high income taxpayers than similar taxpayers in West Virginia? Will the examinations be geographically proportionate?

Tools for Analyzing Indirect Effects are Available

The IRS cannot entirely blame a lack of data or research infrastructure for its current inability to take a proactive research-based approach to its examination strategy. The IRS has made progress in getting its Compliance Research Information System (CRIS) online, obtaining fresh NRP data on taxpayer compliance, and improving data analysis capabili-

Administration, *Opportunities Exist to Improve the Administration of the Earned Income Tax Credit*, Reference No. 2003-40-139 (June 2003). It is unclear whether such examinations were the most effective use of IRS resources to improve compliance among taxpayers claiming the EITC. *See* Leslie Book, *EITC Noncompliance: What We Don't Know Can Hurt Them*, 2003 TNT 121-27, 5 (June 24, 2003).

[47] *See, e.g.*, Jon S. Davis, *et. al.*, *Social Behaviors, Enforcement, and Tax Compliance Dynamics*, 78 The Accounting Review 39 (2003); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L. J. 1453, 1486-14 (2003).

[48] *See* Stephen Coleman, The Minnesota Income Tax Compliance Experiment: State Tax Results, Minnesota Department of Revenue (April 1996). *See also*, Kim M. Bloomquist, Tax Evasion, *Income Inequality and Opportunity Costs of Compliance*, Proceedings of the 96th Annual Conference on Taxation: 2003, Chicago, IL: National Tax Association (Nov. 2003) (available at http://www.irs.gov/pub/irs-soi/bloomq.pdf).

ties since *Compliance 2000* was abandoned.[49] The IRS also plans to expand its matching programs to include state employer wage data to identify business nonfilers, and to collaborate with state governments in the area of Abusive Tax Avoidance Transactions.[50] The IRS may be able to use data from its current partnerships with the states to estimate geographic differences in the indirect effects of examinations. Existing research into the causes of noncompliance can also be used as a foundation for analyzing indirect effects of different types of examinations among discrete taxpayer segments.[51]

Existing Compliance Research

As noted previously, economists have estimated the indirect effect of an examination on voluntary compliance to be between six and 12 times the amount of the proposed adjustment.[52] For example, in 1991 an average audit resulted in a proposed adjustment of $7,986, but was estimated to indirectly produce an additional $93,217 (11.67 times the proposed adjustment) in revenue resulting from increased voluntary compliance.[53] Stated another way, the indirect effect of an examination on voluntary compliance is estimated to be between about 86 and 92 percent of the total effect (*i.e.*, the sum of the direct and indirect effect) of an examination.[54] IRS researchers have hypothesized that the indirect effect of an examination varies among taxpayer segments, and that an understanding of these differences is much more crucial to the allocation of audit resources than the direct yields produced by examinations.[55]

Indirect Effects by Type of Noncompliance

The indirect effects of examination activity are likely to vary among noncompliant taxpayers based upon the cause of their noncompliance. Sociologists have identified the following types of noncompliance:

---

[49] *See, e.g.*, SB/SE Research, Small Business/Self Employed, *Compliance Risk Assessment, FY 04-05 Strategic Planning Cycle* (Jan. 31, 2003).

[50] See IRS, *Strategic Plan 2005-2009*, Publication 3744, 20 (Rev. 6-2004).

[51] *See, e.g.*, Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, 2 TAXPAYER COMPLIANCE 57 (1989).

[52] Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96), Washington, DC, pp 35-36 (estimating that the indirect effect of every dollar of proposed audit adjustments was an increase in voluntary tax reporting by $11.67); Jeffrey A. Dubin, Michael J. Graetz and Louis L. Wilde, *The Effect of Audit Rates on the Federal Individual Income Tax*, 1977-1986, 43 NAT. TAX J., 395, 396, 405 (1990) (estimating that the indirect effect of an examination was about 6 times the resulting assessments, that is, examinations resulting in assessments of $2.6 billion would increase voluntary taxes reported by $15.6 billion or six times the assessment amount.).

[53] Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96), Washington, DC 1996, 35-36.

[54] Even this may be a significant understatement of the relative importance of the indirect effect of examinations given the fact that the IRS is estimated to collect only 20 to 43 percent of any proposed adjustment over time. *See* General Accounting Office, *IRS Measures Could Provide A More Balanced Picture of Audit Results and Costs*, GAO/GGD-98-128, 4 (June 1998).

[55] *See* Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96), Washington, DC, 35-36.

- *Procedural noncompliance:* Administrative complexity is a hurdle to compliance.
- *Lazy Noncompliance:* Taxpayers are unwilling or unable to satisfy the requirements for compliance.
- *Unknowing Noncompliance:* Taxpayers experience confusion about the rules for compliance.
- *Asocial Noncompliance:* Taxpayers engage in classic tax cheating.
- *Brokered Noncompliance:* Taxpayers' reliance on advice of tax professionals results in noncompliance.
- *Symbolic Noncompliance:* Taxpayers do not comply because they perceive inequities in the operation of the tax laws or tax administration.
- *Social Noncompliance:* Social or economic circumstances (e.g., social norms) create an environment that does not discourage cheating.
- *Habitual Noncompliance:* Taxpayers develop a history of noncompliance and become emboldened by "getting away" with noncompliance in past years.[56]

As an example, examinations are likely to have a greater indirect effect on social than on procedural noncompliance. Taxpayers who are procedurally noncompliant would probably benefit more from education and assistance in tax preparation than from an increasing likelihood of audit. A greater understanding of the reasons for non-compliance among various taxpayer groups and the responsiveness of each group to examinations could help the IRS improve the effectiveness of its examination strategy in reducing the tax gap.

Maximizing Indirect Effects by Changing Community Norms

The notion that different taxpayer groups respond differently to an increasing examination rate is consistent with "social norm" explanations of tax compliance behavior offered by tax scholars. There is a widespread consensus among these scholars that deterrence does not explain voluntary tax compliance because the probability that the IRS would detect cheating is trivial and the penalty is small.[57] That is, why not cheat if you are unlikely to get caught and even if you do get caught the penalty is small? Some have concluded that the explanation for widespread tax compliance is that people are obeying a "social norm."[58] Social norms are nonlegal rules that people follow because they obtain either satisfaction from doing the right thing (or absence of guilt) or approval from others

[56] *See* Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 KAN. L. REV. 1145 (2003), *citing*, Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, 2 TAXPAYER COMPLIANCE 57 (1989).

[57] *See, e.g.*, Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1782 (Nov. 2000). *See also*, Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L. J. 1453, 1457-1459 (Dec. 2003). This describes a type of "asocial noncompliance," *e.g.*, where the taxpayer objectively calculates costs and benefits of compliance.

[58] *See, e.g.*, Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1782 (Nov. 2000).

(or absence of disapproval, stigma or ostracism by others).[59] That is, if a person belongs to a community that would ostracize tax cheaters, he or she is less likely to cheat than a person whose community accepts tax cheating as the norm. This theory is supported by surveys indicating that those who report compliance believe that their peers and other taxpayers in general comply, that is, they believe compliance is the norm.[60] Studies confirm that taxpayers exhibit increased compliance after being told that other taxpayers are compliant.[61] Perhaps such publicity reinforces social norms of tax compliance.

However, in communities where noncompliance is the norm, such as some cash economy business communities that are the largest contributor(s) to the tax gap, taxpayers may already assume that others are noncompliant.[62] In such cases, increasing tax examinations may be a particularly effective way to increase tax compliance norms.[63] Examinations targeting a specific community with tax cheating norms could "tip" a norm of noncompliance into one of compliance.[64]

A threshold level of examinations may be required to make the payment of taxes economically feasible for participants in markets where tax cheating is so rampant that the market price of a good or service does not reflect tax compliance costs.[65] Without IRS enforcement against noncompliant businesses, compliant businesses are at a competitive disadvantage and may simply leave the market. This suggests that in some communities the marginal indirect effect of examinations is likely to increase dramatically as the increase in examinations changes community norms.[66]

> **Example:** Assume, for example, that underreporting is rampant among drywall contractors in a particular community. When audits begin to cause enough drywall contractors in that community to pay taxes that those who pay no longer feel foolish and the local price of drywall services begins to increase so that paying taxes and staying in business are not mutually exclu-

[59] Ann E. Carlson, *Recycling Norms*, 89 CA. L. REV., 1238 (Oct. 2001).

[60] *See* John S. Carroll, *How Taxpayers Think About Their Taxes: Frames and Values*, Why People Pay Taxes, 43, 47 (Joel Slemrod ed., 1992).

[61] *See generally*, Stephen Coleman, *The Minnesota Income Tax Compliance Experiment: State Tax Results* (April 1996).

[62] *See, e.g.*, Joseph Bankman, *Tax Enforcement: Tax Shelters, The Cash Economy, and Compliance Costs*, 2004 TNT 134-43, Doc 2004-13203, July 12, 2004, 189. Noncompliance based upon a community norm is "social noncompliance."

[63] A recent survey found that personal integrity was the single most important reason cited for tax compliance. RoperASW, *2003 IRS Oversight Board Compliance Study Report* (Sept. 2003), 2. This may support the hypothesis that social norms play an important role in tax compliance behavior.

[64] *See* Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L. J. 1453, 1482-1501 (Dec. 2003).

[65] *See id*.

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

> sive choices, the voluntary compliance revenue generated from each additional audit is likely to be significantly more than the marginal revenue generated by the first audit in that community.

The IRS could use its partnerships with state taxing authorities, local databases (such as property tax records that indicate property disproportionate to reported income),[67] and refined UI-DIF computer screening tools to identify taxpayer segments where noncompliance is the norm and examinations might have a dramatic effect on voluntary compliance. In such communities, if the IRS increased audits that cover information reporting compliance, the audits could have a significant ripple effect on compliance by suppliers.[68] That is, even though an audit covering information reporting is unlikely to generate significant direct revenue, suppliers may be less likely to underreport income if their customers comply with information reporting requirements. However, any such strategy would benefit from a greater understanding of how examinations can work to change community norms.

IRS COMMENTS

The IRS agrees that the tax gap is a serious problem. To address this problem, the IRS has many efforts underway to develop and enhance an examination strategy for more effective allocation of resources and improved selection of cases relative to the examination program. Most of the discussion in the TAS report is based on selected, observed IRS actions and the findings of various research studies conducted over many years. However, the conclusions and recommendations reached in the report do not reflect a full understanding of the examination function in tax administration.

The IRS uses a three-dimensional strategy to accomplish its mission relative to examinations and address the reporting compliance tax gap. These dimensions are not mutually exclusive and their allocation relies to a great degree on management judgment. From year to year, the IRS balances its examination resources to address these three dimensions, as part of its strategy to close the tax gap.

> **Provide Audit Coverage** – Maintaining an effective level of audit coverage provides a broad enforcement presence and encourages the annual voluntary net collection of approximately $1.7 trillion in revenue. This examination "presence"

[67] This has been recommended by others. *See, e.g.*, Joseph Bankman, *Tax Enforcement: Tax Shelters, The Cash Economy, and Compliance Costs*, 2004 TNT 134-43, Doc 2004-13203, July 12, 2004, 189; American Bar Association Commission on Taxpayer Compliance, *Report and Recommendations on Taxpayer Compliance*, 41 Tax Law. 329, 336-361 (1988).

[68] Professor Bankman suggests that IRS auditors rarely examine compliance with information reporting requirements because they are primarily focused on reporting of income by the taxpayer under audit. Joseph Bankman, *Tax Enforcement: Tax Shelters, The Cash Economy, and Compliance Costs*, 2004 TNT 134-43, Doc 2004-13203 (July 12, 2004), 189.

promotes the fairness of the tax system by ensuring that taxpayers are paying the correct amount of tax. Audit coverage also provides stability to voluntary compliance by preventing erosion of the voluntary reporting and payment of taxes owed.

Mitigate Risk to the Tax System – Directing examination resources to those segments of the population that use egregious tax avoidance strategies or fail to file returns is another important dimension of the examination strategy. Specific programs to deal with these forms of noncompliance are critical if the IRS is to assure the taxpaying public that the tax system is fair, i.e., all taxpayers are expected to pay their "fair share," and those who don't will be detected. Taxpayers who believe the system is fair are far more likely to correctly report and pay their taxes.

Generate Enforcement Revenue – Focusing on potential enforcement revenue is an integral part of the IRS strategy to address underreporter non-compliance and select returns for examination, whether for audit coverage or risk mitigation. Higher potential for tax adjustments (enforcement revenue) signals a higher degree of noncompliance. Giving priority to these cases not only impacts direct and indirect compliance, but is also an effective use of IRS resources.

Conducting probes for unreported income is a standard element of both business and non-business examinations. In addition, the IRS continues to conduct research into improved methods to detect unreported business income. In particular, the IRS is using selection formulas based upon the DIF system to select and audit returns showing high probabilities for unreported income.

The IRS has not abandoned the strategies and methodologies learned from the Compliance 2000 projects of the early 1990's. The IRS has, in fact, integrated many of the principles and methodologies of the Compliance 2000 initiative noted in the TAS report. For instance, in the current tax shelter initiatives, the IRS is offering settlements in lieu of full-scale audits in cases where issues are clearly defined. Also, in a number of its programs, the IRS uses soft notices to encourage taxpayers to correct apparent errors on their tax returns. In addition, increased pre-filing efforts (modeled after Compliance 2000 approaches) have resulted in marketing, education and outreach to promote an Employment Tax Strategy within specific industries and TIP reporting agreements to help both employees and employers meet their respective tax obligations without enforcement intervention.

The Large & Mid-Size Business (LMSB) Operating Division is implementing the Compliance Assurance Program (CAP) which provides improved service to taxpayers and increased compliance with tax laws through real time monitoring, review and issue resolution. This is exactly the kind of approach envisioned in Compliance 2000. CAP builds on the experience gained from the Industry Issue Resolution (IIR) program (working with industry groups to address the compliance of groups of taxpayers in specific areas) and from the Limited Issue Focused Examinations (LIFE).

Every year, the IRS invests significant resources, both internally and externally, to research tax compliance behavior. Currently, SB/SE Research is conducting approximately 50 projects regarding examination issues. In addition to these smaller, more targeted efforts, the IRS recently completed the National Research Program (NRP). The IRS dedicated significant resources to this program, examining approximately 46,000 returns and spending more than $100 million. Information gathered from this effort will allow the IRS to improve its audit selection formulas, develop more current tax gap estimates, and update the measures on taxpayer compliance. This information will be used as a benchmark in future years to direct the allocation of resources to address compliance issues. Expanded reporting requirements, such as the new Schedule M-3 and Form 8858, increase the information available to the IRS to pinpoint non-compliance, particularly in the large corporate population.

The TAS report recommends that the IRS plan its examination strategy to take advantage of the indirect effect of its audits and to maximize the collectibility of the resulting assessments. The indirect effect of examinations is a component in establishing audit coverage each year. Our focus on areas of non-compliance and high risk, such as abusive schemes and offshore initiatives, is intended to create a ripple effect. While there are no proven quantitative measurements regarding the indirect effect, the IRS continues to enhance workload identification selection systems to maximize indirect benefits across broad groups of taxpayers.

Similarly, the collectibility of assessments resulting from examinations has long been a topic of discussion among compliance strategists. However, there is no proven method for determining, in advance, the collectibility of a potential assessment. There are too many factors that impact on collectibility in a particular case. The examination process is designed to ensure fair and equitable treatment of taxpayers in addressing reporting non-compliance. To address collectibility issues, the IRS Collection operation has developed a number of process enhancements to increase its ability to collect tax liabilities in a timely manner. Performance data indicates that these initiatives are working – for FY 04, total dollars collected increased by 15 percent.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate agrees that the IRS cannot ignore egregious tax avoidance strategies and must maintain some minimal level of audit coverage. In addition, she commends the IRS for:

- *Attempting to enhance its return selection systems to maximize indirect effects across broad groups of taxpayers;*
- *Completing the National Research Program (NRP) to obtain fresh compliance data;*
- *Ongoing research to improve methods to detect unreported business income; and*
- *Using soft notices and pre-filing efforts to promote voluntary compliance.*

The Large and Mid-Size Business (LMSB) Operating Division also should be commended for efforts to improve service and compliance through its Compliance Assurance Process and the new Schedule M-3 (Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More).[69] *However, the IRS' new examination initiatives do not specifically address underreporting by small business and self-employed taxpayers, which represent the largest component of the tax gap.*[70]

IRS comments indicate that the first two prongs of its three dimensional examination strategy, maintaining audit coverage and directing resources towards egregious tax avoidance strategies and nonfilers, are intended to promote the fairness of the tax system, thereby increasing voluntary compliance. However, almost any examination strategy is likely to promote voluntary compliance. The real question is whether the IRS is using the most effective strategies to promote voluntary compliance. The IRS has cited no evidence that its examination strategies are actually the most effective strategies for promoting voluntary compliance, or even the most effective examination strategies. In fact, there is little evidence that average business taxpayers, who are the largest contributors to the tax gap, will be affected by initiatives targeting other taxpayer groups. Furthermore, to our knowledge the IRS has not integrated these initiatives with strategies or studies that would measure their impact on voluntary compliance.

The third prong of IRS' strategy is to maximize enforcement revenue based on the assumption that this is the most effective use of IRS resources. However, IRS cites no evidence that maximizing enforcement revenue is actually an effective use of IRS resources. In fact, IRS researchers have previously estimated that certain ***non-enforcement*** *strategies are more cost effective in maximizing revenue than many enforcement strategies, and that sending Tax Delinquency Investigation Notices (nonfiling notices) was the most cost effective enforcement strategy.*[71] *Whatever strategy is adopted should be based on the best research available, and if actionable research is lacking, further research should be pursued.*

[69] The Compliance Assurance Process allows the IRS, working in conjunction with the taxpayer, to determine tax return accuracy prior to filing. The Schedule M-3 facilitates examinations of large corporations by disclosing the information needed to reconcile book and tax income.

[70] *See* Key Legislative Recommendation: Tax Gap Provisions, *infra*.

[71] Alan H. Plumley, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, Publication 1916 (Rev. 11-96), Washington, DC, 40.

RECOMMENDATIONS

Because studies have concluded that examinations reduce the tax gap primarily through an indirect effect on voluntary compliance, the IRS should further research such effects.[72] *The IRS should estimate how such indirect effects vary by taxpayer segments, issues examined, and type of examination (e.g., face to face or correspondence). It should use this research to determine which returns to examine, which issues to examine and what type of examination to use. In the meantime, the IRS should use its partnerships with state taxing authorities, local databases (such as property tax records that indicate property disproportionate to reported income) and improved UI-DIF computer screening tools to identify taxpayer segments and communities where noncompliance is the norm. Conducting additional examinations in such communities is likely have a dramatic indirect effect on voluntary compliance as it changes community norms.*

The IRS should develop procedures for quickly estimating how effectively a given strategy increases voluntary compliance in a given community. The availability of such estimates would give the IRS an alternative to evaluating examination initiatives based on dollars assessed, which may have no correlation with the effectiveness of an initiative in achieving tax gap reduction goals. In addition to relying on traditional IRS data sources to make such estimates, IRS could survey local market prices for goods or services to determine if they reflect tax compliance costs as well as the attitudes of various taxpayer groups towards tax compliance.

The IRS should consider adopting a policy of routinely auditing information reporting compliance, even though such procedures may be unlikely to significantly increase assessments. Such audits would promote information reporting compliance. Increased information reporting compliance could have a significant effect on underreporting since taxpayers are more likely to report income if they know it has been reported to the IRS.

The IRS should also research the national and local causes of noncompliance. An understanding of why examinations are more effective among some populations and for certain tax issues will help IRS identify the most cost effective way of addressing noncompliance. Along the same lines, the IRS should revisit the basic components of Compliance 2000 that were successful or that could now be successful given IRS' improved research capabilities and fresh NRP data. Specifically, it should consider giving local areas more research tools, latitude and incentives to address non-compliance among local taxpayers, and then evaluate the success of such local approaches so that successful strategies can be replicated elsewhere.

[72] For example, even after IRS issues a notice of intent to levy on federal payments, the GAO has estimated that 73 cents out of every dollar that is collected is paid voluntarily, rather than by levy. General Accounting Office, *Federal Payment Levy Program Measures, Performance, and Equity Can Be Improved*, GAO-03-356, 6-8 (March 2003).

PROBLEM

TOPIC D-15 MOST SERIOUS PROBLEM: IRS COLLECTION STRATEGY

RESPONSIBLE OFFICIALS

Henry O. Lamar, Jr., Commissioner, Wage and Investment Division
Kevin M. Brown, Commissioner, Small Business/Self Employed Division

DEFINITION OF THE PROBLEM

The collection function within the IRS collects unpaid assessments and is responsible for ensuring that individuals and entities that are required to file tax returns actually do so. The IRS collection function is an essential component of our tax administration system. Notwithstanding the importance of the collection function, the IRS has failed to develop an effective, comprehensive and consistent collection strategy to counter the two most serious threats to our tax administration system: the ever widening tax gap[1] and the decline in tax compliance. Over the last decade, the IRS' approach to collection strategy has been marked by dramatic shifts in emphasis; however, these shifts have not sought to harmonize effective collection strategies used in the private sector with strategies designed to address the causes of noncompliance. Because the IRS is again altering the collection landscape in favor of more enforcement,[2] it is an appropriate time to identify the essential components of a single, farsighted collection strategy that harmonizes the goals of tax collection and tax compliance by:

1. prompting human contact with delinquent taxpayers;
2. understanding the *why* of taxpayer noncompliance;
3. identifying the appropriate collection touch for the particular cause of noncompliance;
4. taking a research based approach; and
5. reducing opportunities for noncompliance.

ANALYSIS OF THE PROBLEM

Several years ago the IRS revised its mission statement that had prevailed since the 1960's. The old IRS mission statement provided:

> The purpose of the Internal Revenue Service *is to collect the proper amount of tax revenue* at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting

[1] The gross tax gap is the amount of tax that is imposed by law for a given tax year but not paid voluntarily or timely. IRS National Headquarters Office of Research, Tax Gap Map for Year 2001 (Feb. 24, 2004); *see also* General Accounting Office, *Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO-94-123, 10 (May 1994).

[2] As Internal Revenue Service Commissioner Mark W. Everson recently noted to the Internal Revenue Service Advisory Council (IRSAC): "The word 'enforce' is one that people didn't even like to use when I turned up here. That's not the case anymore." Heidi Glenn and Warren Rojas, *Everson Delays EITC Certification Effort, Backs Other IRSAC Ideas*, 105 Tax Notes 905 (2004).

> the highest degree of public confidence in our integrity and fairness.[3]

The old mission statement emphasized the collection of a sum certain owed by the taxpayer. In 1998, the IRS revised its mission statement as part of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).[4] The new IRS mission is:

> Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities by applying the tax law with integrity and fairness to all.[5]

The new mission statement emphasizes tax compliance and the duty of the IRS to assist taxpayers in meeting their tax obligations. Critics of RRA 98 have pointed to the omission of the words "to collect" from the revised mission statement as evidence of a shift in emphasis away from collections. These voices inside and outside the IRS have argued that the decline in collections activity within the IRS was brought about by RRA 98.[6] The National Taxpayer Advocate rejects this premise. Taxpayer rights and higher rates of tax compliance can coexist and do not reflect opposing values.

While it may be tempting for some to blame the enactment of RRA 98 for the IRS diminished collection performance, it is clear that prior to 1998 the tax gap was expanding while collection efforts were stagnant.[7] For example, in the years 1988 throughout 1992, the collection of delinquent accounts was stagnant at approximately $23 billion per year, while the gross accounts receivable inventory increased annually by approximately $10 billion in each year, extending the annual gross tax gap to $127 billion dollars by 1992.[8] Current figures indicate that collection enforcement revenue is approximately $34

[3] Policy Statement P-1-1, Status (approved Dec. 18, 1993) (from 1998 Internal Revenue Manual). [emphasis added].

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

[5] IRM 1.1.1.1(1).

[6] Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L. J. 1453, 1458 (2003), citing various RRA 98 provisions as contributors to the change in morale of IRS collection personnel, such as the enactment of RRA 98 § 1203(b) which established the so-called the "ten deadly sins" of conduct for which IRS employees can be fired. It is difficult to understand how the enactment of such common sense provisions (that are hardly Draconian compared with employee standards in the private sector) would keep dedicated employees from doing their jobs. For example, RRA 98 § 1203(b)(4) makes the destruction of documents by IRS employees to cover up employee mistakes a terminable offense. Assuming such conduct to be rare (as the National Taxpayer Advocate believes it to be), such common sense provisions as RRA 98 § 1203 should not alter the professionalism and morale of IRS collections employees.

[7] The gross tax gap is the amount of tax that is imposed by law for a given tax year but not paid voluntarily or timely. IRS National Headquarters Office of Research, Tax Gap Map for Year 2001 (Feb. 24, 2004); *see also* General Accounting Office, *Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO-94-123, 10 (May 1994).

[8] *Id.* at 29.

billion per year,[9] with the gross tax gap estimated at about $310 billion per year.[10] In other words, while annual collections have increased by $11 billion (or 48 percent) over the past ten years, the gross tax gap has expanded by over $183 billion (or 144 percent). Moreover, ample time has elapsed since the enactment of RRA 98, and still, by its own admission, the collection function is a "high risk/material weakness" within the IRS.[11]

There are trends other than the tax gap that warrant a new approach toward collections. Evidence suggests that voluntary compliance, the bedrock of our tax system, is eroding.[12] While there has been a strong social norm in this country toward paying taxes, recent studies suggest that one in five taxpayers now believe it is acceptable to cheat on their tax returns.[13] It is reasonable to conclude that there are fundamental problems with the collections process that are unrelated to RRA 98.

Other voices inside and outside the IRS have noted a single-mindedness about IRS collection strategy (pre and post-RRA 98) which has tended to chase today's delinquent tax dollars without a goal of ensuring tomorrow's tax compliance.[14] The rigid collection process, which includes streams of threatening notices and minimal substantive human contact, is largely indifferent and unresponsive to the causes of noncompliance. Many private credit institutions, which unlike the IRS have the luxury of terminating a debtor's future credit allowances upon default, understand that modern collections theory and practice requires substantive human contact with debtors early on in the collections process in order to tailor collection strategies to fit the causes of delinquency.[15]

The first step towards greater tax compliance is the recognition that there are different reasons why taxpayers become noncompliant, and if we understand the reasons for their noncompliance, we can apply the most effective tools to remedy noncompliance.[16] By focusing on tax compliance, the IRS will be able to accomplish two vitally important goals: narrowing the tax gap and bringing more nonpaying taxpayers back into the system. In the analysis below, the National Taxpayer Advocate sets forth her strong support for this approach. As the tax gap is the driving force behind the needed reforms to the IRS collection process, it is first necessary to analyze the components of the tax gap in greater detail.

[9] Treasury Inspector General For Tax Administration, *Trends in Compliance Activities Through Fiscal Year 2003*, Reference No. 2004-30-083, 2 (April 2004),

[10] IRS National Headquarters Office of Research, *National Research Program*, "Tax Gap Map for Tax Year 2001."

[11] Small Business/Self-Employed Strategic Assessment Report, FY 2005-2006 (February 23, 2004).

[12] Amy Hamilton, *The Tax Gap and Inklings of a Focus on Noncompliance*, 79 Tax Notes 933 (1998) (citing then IRS Commissioner Charles Rossotti).

[13] IRS Oversight Board, *Annual Report*, 1 (August 2004).

[14] Alan H. Plumley and C. Eugene Steuerle, *The Crisis in Tax Administration*, *Ultimate Objectives for the IRS*: Balancing Revenue and Service, 311, 329.

[15] Ann McDonald, *Better Connections*, 9 Coll. & Credit. Risk, March 2004, 68-69.

[16] Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003).

Tax Gap

The tax gap is an important measure of the success of the IRS' collection results because it measures the difference between what taxpayers owe the Federal government and what they pay. The IRS has been measuring the tax gap for over 20 years.[17] In 1981, the gross tax gap was estimated to be $76 billion, and in 1992 it was estimated at $127 billion, an increase of 67 percent.[18] For the year 2001, the gap was estimated to be $310 billion, an increase of 144 percent from 1992.[19] Therefore, the tax gap is not just growing, it is growing at ever-expanding rates.

The tax gap is not comprised entirely of underpayments. Using the most recent figures estimated by the IRS, the components of the gross tax gap are taxpayers who:

- underreport income ($249 billion);
- fail to file tax returns ($30 billion); and
- fail to pay what is owed ($32 billion).[20]

The IRS collection function is responsible for addressing both non-filing and non-paying taxpayers, meaning that approximately $62 billion of potential revenue went uncollected by the function in 2001.

As the tax gap expands, it places a greater burden than ever before on compliant taxpayers.[21] Additionally, more Americans than ever before believe that it is acceptable to cheat on their tax returns.[22] In light of the growing tax gap and the changing social norm away from tax compliance in our country, it is time to ask the question: *Is the IRS collection strategy sufficient to shrink the tax gap and stem the rising tide of noncompliance?* To answer this question, we must examine the basic structure of the IRS collection process.

IRS Collection Process

The collection process begins with an assessment, which can occur through three different methods:

- self-assessment by the taxpayer when a tax return is filed;[23]

[17] General Accounting Office, *Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO-94-123, 3 (May 1994).

[18] The net tax gap is the amount that remains due after late payments and enforced collection actions are undertaken. For the year 2001, the net tax gap was estimated to be $255 billion. General Accounting Office, *Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed*, GAO-94-123, 13 (May 1994).

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

[20] *Id.*

[21] IRS National Headquarters Office of Research, *National Research Program*, "Tax Gap Map for Tax Year 2001."

[22] In response to the question "How much if any do you think is an acceptable amount to cheat on your income taxes?", the percentage saying "Not at all" dropped from 86 percent in 2002 to 81 percent in 2003. 2003 IRS Oversight Board, *Annual Report*. 6.

[23] IRC § 6201.

- IRS assessment following deficiency procedures and after the taxpayer has exhausted (or failed to exercise) all rights of appeal;[24] and
- an IRS-prepared "substitute for return" (SFR) where the taxpayer has failed to file a timely tax return.[25]

When an assessment is made but no payment is forthcoming, the IRS begins the collection process, which many refer to as a three stage process.[26] The three stages are: the notice stream, the Automated Collection System (ACS) and the Collection Field function.

First Stage - Notice Stream

The first stage is known within the IRS as the "notice stream" and involves four notices being sent to the taxpayer, beginning with a Notice and Demand for Payment. The four notices are sent to the taxpayer from between five to six weeks apart. In the six months that elapse from the first notice to the last, the IRS makes no to contact the taxpayer by phone or in person.

Additionally, it is in this first phase of collection that the IRS makes assessments about the risk of the delinquent account. Collection cases are managed by the IRS Inventory Delivery System (IDS), which routes cases depending on the IRS Risk-Based Collection criteria.[27] The risk assessment is performed in an effort to ensure that the most productive cases will be worked by the collection function. Cases are analyzed for priority and assigned a priority code based on: high, medium and low risk scores.[28] The risk scores depend on different facets of the tax. For example, the type of tax affects the risk score such that trust fund cases are assigned a higher risk.[29] The age and amount of the tax also affect risk score; thus, newer taxes and those of higher dollar value are considered higher risks.[30]

After the notice stream, the second stage for most accounts is the ACS. One exception to this general rule is that higher risk cases are placed into an electronic holding bin (known within the IRS as the "Queue") to await assignment to the Collection Field function, which in theory provides a higher level of attention to high priority cases.[31]

[24] IRC § 6212.

[25] IRC § 6020(b).

[26] General Accounting Office, *Tax Administration – New Delinquent Tax Collection Methods for IRS*, GAO-93-67, 1 (June 1993).

[27] IRM 5.1.1.13 (1-01-03).

[28] IRM 5.19.5.3.1. (1-01-03).

[29] IRM 5.1.1.13 (1) (1-01-03).

[30] As part of its collection redesign effort, the IRS has begun experimenting with "decision analytics" software which incorporates taxpayers' compliance history into the risk assessment. Treasury Inspector General for Tax Administration, *The New Risk-Based Collection Initiative Has the Potential to Increase Revenue and Improve Future Collection Design Enhancement*, Reference No. 2004-30-165 (September 2004). IRS Wage and Investment Division representatives indicated to TAS that the size of the account is the still the primary determinant as to whether the case is a high, middle or low risk case.

[31] The IRS is also in the initial stages of implementing what is termed "decision analytics" to assess the most productive collection cases to work.

Second Stage - Automated Collection System

For most taxpayers, the second stage in the collection process involves the ACS. The ACS is a computerized inventory system and telephone call center that was designed to assign cases to examiners who interact with taxpayers about delinquent accounts.[32] There are a total of 15 different ACS sites maintained by the IRS Wage & Investment Division (W&I) for wage earning taxpayers and the Small Business/ Self-Employed Division (SB/SE) for business taxpayers. Most wage earners are handled by the W&I ACS call centers after the first stage in the collection process, while some business tax cases, including trust fund cases, are given a higher priority and bypass the ACS to the Queue to await selection by the Collection Field function. After a case arrives at ACS, the IRS checks for levy sources, telephone numbers and other characteristics, resulting in additional computer generated notices to taxpayers.[33]

The ACS collection efforts, handled by Customer Service Representatives (who are now referred to as "Collection Representatives"[34]), primarily respond to phone calls from taxpayers rather than proactively contacting taxpayers. Although the ACS was originally intended to serve as an aggressive outbound call program targeted towards making early attempts to contact taxpayers with delinquent accounts, the program has evolved into primarily taking incoming calls.[35] For example, in fiscal year 2002, 66 percent of the time and resources utilized in ACS were expended on handling incoming calls, 30 percent working inventory, and only four percent placing outbound calls.[36]

Cases that are given a medium or low risk score are assigned directly to ACS after the notice stream. SB/SE representatives have indicated that if medium risk cases are not resolved within 26 weeks, they are sent to the Queue where they will be shelved after 52 weeks.[37] Low risk cases remain in ACS without being sent to the Queue and are shelved after 65 weeks. New procedures have also been established to designate more cases as currently not collectible (CNC) based on taxpayer characteristics, before the cases even get to the ACS. Although accounts may be designated as CNC within a relatively short period of time, the date beyond which the IRS can no longer pursue collection actions against the taxpayer is 10 years from the date of assessment.[38]

[32] IRM 5.19.5.1 (12-01-00).

[33] IRM 5.19.5.3(2) (12-01-00).

[34] IRM 21.1.1. I.

[35] Treasury Inspector General for Tax Administration (TIGTA), Management Advisory Report: *Progress Has Been Made to Consolidate the ACS Workload, but Achieving Employee Skill Specialization Remains an Uncertainty*, Reference No. 2002-30-166, 33 (September 2002).

[36] Treasury Inspector General for Tax Administration (TIGTA), Management Advisory Report: *Budget Issues Are Delaying the Expanded Use of Predictive Dialer Systems for Contacting Delinquent Taxpayers*, Reference No. 2003-30-132, 5 (June 2003)

[37] The term "shelved" as used in this analysis means to designate as currently not collectible. IRM 5.16.1.2.

[38] IRC § 6502.

The Queue

While not technically one of the stages in the collection process, the Queue is an electronic inventory that holds tax delinquent accounts and investigations until a revenue officer is available to work the case. The Queue also receives medium risk cases that were not resolved in ACS and also higher priority cases which need to wait in the Queue until there is a collection revenue officer to take the case. The Queue's inventory of accounts receivable has been increased over the past few years, despite the fact that $19.8 billion in taxpayer delinquent accounts (TDAs) were removed from Queue between fiscal year 2001 and 2003 and 10.7 million tax delinquent investigations (TDIs) were removed as well.[39]

Third Stage - Collection Field Function

The Collection Field function constitutes the final collection stage, though only "high risk" cases are actually assigned to this stage of the process. In this stage, a revenue officer will try to make direct contact with the taxpayer. The Collection Field function consists of revenue officers who are assigned the highest priority cases off the Queue to investigate, i.e. contact the taxpayer, investigate sources of assets from which the IRS can collect via levy etc. In proportion to the total population of collection cases that are unresolved after the notice stream and the ACS, few cases are actually received in the Collection Field function. Higher risk cases are routed electronically to the Queue to await assignment to the Collection Field function. However, TAS has learned that the Collection Field function is only able to work approximately 35 percent of the "high risk" cases waiting to be chosen inside the Queue.[40] In other words, the IRS bypasses high risk cases around the ACS to be worked with special attention within the Collection Field function, yet, only a little more than a third of these high risk collection cases are actually worked.

Critique of Collection Process

For decades, the IRS collection approach as described above has drawn criticism, as demonstrated by this excerpt from a 1992 GAO report:

> Because of convention, IRS has generally followed a lengthy and rigid three-stage collection process that begins with a series of written notices or bills, sent to the taxpayers over a period of about 6 months, followed by telephone calls, and ends with visits to the delinquent taxpayers. Because of legal restrictions, IRS handles all aspects of delinquent tax collection itself and does not evaluate or reward its collection staff on the basis of collections performance. Because of inadequate information systems, IRS pursues delinquent accounts without knowing whether the amounts recorded in the accounts are valid receivables and with only limited knowledge about the characteristics of the delinquent taxpayers.[41]

[39] Treasury Inspector General for Tax Administration (TIGTA), Management Advisory Report: *Trends in Compliance Activities Through Fiscal Year 2003*, Reference No. 2004-30-083, 5 (April 2004).

[40] IRS Collection Inventory Delivery Document (August 2004).

[41] General Accounting Office, *Tax Administration – New Delinquent Tax Collection Methods for IRS*, GAO-93-67, 1 (May 1993).

Most creditors do not rely on debtors to make the necessary contacts regarding delinquent accounts as the IRS does during the six month notice stream.[42] Instead, most creditors appreciate that establishing contact with the debtor early on in the process is essential and the passage of time for that contact only reduces the likelihood that the debtor will fully or even partially satisfy the debt. There are a number of different reasons why speed in contacting the debtor is essential. For example, in many instances, creditors are competing with one another in a race to get cash-strapped debtors to commit resources to resolve or partially resolve delinquencies.[43] Public sector creditors are no exception, and in many instances, the IRS will find itself competing with more nimble and effective state tax collectors.[44] Contacting a debtor by telephone within 60 days after an account is determined to be past due is generally a minimum standard for private industry.[45] Many state taxing authorities also strive to make direct telephone contact within 30 to 90 days after taxes are past due.[46] Table 1.14.1 below displays IRS statistics that indicate the diminishing returns on accounts with the passage of time and demonstrates that delinquent debts are nearly uncollectible after three years.[47]

TABLE 1.15.1, DECLINING RECOVERY WITH PASSAGE OF TIME

Current	1 Month Past Due	3 Months Past Due	6 Months Past Due	9 Months Past Due	12 Months Past Due	24 Months Past Due	36 Months Past Due
$1.00	.97¢	.72¢	.53¢	.43¢	.28¢	.13¢	.0¢

In the IRS collection system, no person-to-person contact is even contemplated, much less attempted, during the 6 month notice stream phase of collections, unless the delinquent taxpayer initiates the contact. Consequently, using the IRS statistics, the government loses .47¢ on the dollar before the IRS collection process even attempts an IRS initiated person-to-person contact.

The ACS is the first stage when the IRS initiates any person-to-person contact with the

[42] *Id*. at. 5. Even during the ACS collection stage, only a small percentage of calls are initiated by the IRS.

[43] Darren Waggoner, *Not Your Father's Call Center*, 8 Coll. & Credit. Risk, September 2003, 46.

[44] Citing examples of instances where states levied the assets of chronically delinquent taxpayers while IRS chose not to levy in those instances. General Accountability Office, *Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-94, 20 (February 2004); *see also* General Accounting Office, *Tax Administration: State Tax Administrators' Views on Delinquent Tax Collection Methods*, GAO/GGD-94-59FS (February 1994).

[45] General Accounting Office, *Tax Administration – New Delinquent Tax Collection Methods for IRS*, GAO-93-67, 5 (May 1993).

[46] *Id.*

[47] IRS Automated Collection System Operating Model Team, *Collectibility Curve* (August 5, 2002). This IRS assessment of diminishing returns with the passage of time also reflects the experience of private collection agencies attempting to collect non-tax debt. The Commercial Collection Agency Section of the Commercial Law League of America published the results of a survey of its members in *Collection Trends*, dated July 25, 2001, indicating that on average only 10¢ of every dollar is collectible after the expiration of two years.

taxpayer; however, the chances of such a contact occurring are miniscule.[48] The ACS sites have evolved into call-in centers rather than call-out centers, and relatively few resources are allocated to calling delinquent taxpayers.[49] Calls coming into the ACS are often from taxpayers seeking information other than payment related information, and when the calls do relate to payment issues, they often involve the least productive cases.[50]

Insufficient technology and the allocation of resources also play a role in the IRS' failure to timely contact delinquent taxpayers. Most large private collection call centers rely heavily on a computer controlled telephone technology known as "predictive dialer" systems which automatically call debtors and transfer the calls and account information to an available collection agent if the debtor answers the phone.[51] By eliminating the time spent by collection agents manually attempting to reach customers, the predictive dialer systems give a single collector the ability to speak with a larger number of debtors daily.[52]

The IRS is currently only using one predictive dialer at the Buffalo ACS site to make calls for all of the 15 ACS sites, and the system is shared between W&I and SB/SE.[53] The IRS has been hesitant to fully use its operational predictive dialer because it is concerned that its resources will be consumed on the outgoing calls and resources will not be available for incoming calls.[54] Through September 2004, ACS management reports reflect that direct time dedicated to outgoing calls still remains at approximately 4.6 percent of all ACS direct time.[55] Additionally, the IRS does not use the predictive dialer at all during the notice stream or when cases are sitting in the Queue waiting to be assigned to the Collection Field function.

The only stage in the collection process in which the IRS routinely establishes a person-to-person contact is the Collection Field function. However, by the time a case reaches

[48] In FY 2002, only four percent of ACS resources were expended on outbound calls. Treasury Inspector General for Tax Administration (TIGTA), Management Advisory Report: *Budget Issues Are Delaying the Expanded Use of Predictive Dialer Systems for Contacting Delinquent Taxpayers*, Reference No. 2003-30-132, 2 (June 2003).

[49] Treasury Inspector General for Tax Administration, Management Advisory Report: *Budget Issues Are Delaying the Expanded Use of Predictive Dialer Systems for Contacting Delinquent Taxpayers*, Reference No. 2003-30-132, 2 (June 2003).

[50] *Id.* at 4.

[51] Darren Waggoner, *Not Your Father's Call Center*, 8 Coll. & Credit. Risk, September 2003, 46; *see also* Treasury Inspector General for Tax Administration, *Budget Issues Are Delaying the Expanded Use of Predictive Dialer Systems for Contacting Delinquent Taxpayers*, Reference No. 2003-30-132, 1, footnote 1, (June 2003) describing the predictive dialer as follows:

> A predictive dialer is a telephone control system that automatically calls a list of telephone numbers in sequence and screens out no-answers, busy signals, answering machines, and disconnected numbers while predicting at what point a Customer Service Representative will be able to handle the next call.

[52] Treasury Inspector General for Tax Administration (TIGTA), Management Advisory Report: B*udget Issues Are Delaying the Expanded Use of Predictive Dialer Systems for Contacting Delinquent Taxpayers*, Reference No. 2003-30-132, 6 (June 2003).

[53] Officials within the IRS informed TAS that a back-up predictive dialer was also purchased, and it may be placed into operation so that W&I and SB/SE would each have a predictive dialer, though the extent of use of the second predictive dialer was uncertain due to scarce resources.

[54] Treasury Inspector General for Tax Administration, Management Advisory Report: *Budget Issues Are Delaying the Expanded Use of Predictive Dialer Systems for Contacting Delinquent Taxpayers*, Reference No. 2003-30-132, 5 (June 2003).

[55] ACS Management Reports, October 1, 2003 through September 30, 2004. "Direct time," as used in the ACS Management Reports, excludes overhead expenses.

the Collection Field function, significant time has elapsed in the notice stream and in the Queue. Moreover, as noted above, only high risk cases are allocated to the Collection Field function, and only a little more than one-third of high risk cases eligible to be pulled from the Queue are actually worked by the Collection Field function.

While establishing a priority system is necessary, the existing collection structure does not ensure that the appropriate collection "touch" is given to higher priority cases. For example, the IRS gives a high collection priority to the collection of delinquent payroll taxes, bypassing those cases around the ACS into the Queue to await selection by the Collection Field function.[56] There are a number of reasons which justify assigning a higher priority to payroll tax cases. First, these payroll tax cases often involve investigations under IRC § 6672 to recover portions of payroll taxes withheld from the employee's pay (known as the "trust fund" portion) but not remitted to the IRS by officers or other responsible persons within the business.[57] Second, employment taxes constitute 23 percent of the tax gap.[58] Despite the higher priority assigned to these cases, 65 percent of these high priority cases cannot be worked by the Collection Field function. Additionally, because the IRS does not use the predictive dialer in the notice stream or on cases in the Queue, 65 percent of these high priority cases receive less direct attention than low priority cases that are being worked in the ACS.

In sum, the IRS collection strategy too often employs a one-size-fits-all approach that does not prioritize person-to-person contacts with taxpayers. When the IRS does assign a high priority treatment to a class of cases, these cases can receive less attention than a lower priority case. Moreover, the IRS' own studies have shown that the traditional IRS collection strategy does not alter the patterns of future tax compliance.[59] The IRS needs a different approach to collection strategy.

[56] IRM 5.1.1.13.4.2(1), indicating cases that bypass the ACS and go straight to the Queue as including payroll tax categories.

[57] The trust fund portion of payroll taxes are the amounts withheld from the employee's wages, including income taxes and Social Security and Medicare taxes. Under IRC § 6672, the IRS can seek to establish personal liability upon "responsible persons," i.e. (1) the individual was a responsible person (someone who has the status, duty, and authority over the financial decision-making), and (2) the individual willfully failed to collect, truthfully account for, and pay over trust fund taxes (by knowingly paying other creditors while the trust fund taxes were due the IRS).

[58] Internal Revenue Service, *Strategic Plan 2005-2009*, Publication 3744, 18 (Rev. 06-2004).

[59] A study performed by the IRS in the 1990's demonstrated that its traditional enforcement approach has little to no effect on the future compliance of taxpayers with outstanding liabilities. In this study, the IRS identified varying groups of taxpayers with outstanding liabilities at varying stages of the collection process. Within these groups, the IRS tracked the compliance patterns of taxpayers who had been subjected to various types of enforcement actions, including wage garnishments, account levies, and property seizures. The IRS reviewed the compliance patterns of these taxpayers over a number of years. The results of the studies showed that the taxpayers who had been subjected to enforcement action continued in subsequent years to be highly noncompliant. In other words, they continued to pay late (if at all) and file late (if at all) and continued to be subject to enforcement actions in later years. In sum, traditional enforcement mechanisms did not contribute to future tax compliance. Joel Friedman, IRS Collections, *1990 Research Conference, Impact of Collection Enforcement Activities on Taxpayer Behavior*, Document 7302 (3-91), 143.

A DIFFERENT APPROACH

In the early 1990s, the IRS developed a new approach to tax compliance, including tax collection, which it termed *Compliance 2000*. This was designed to be a research-driven effort that would identify the root causes of noncompliance among market segments and address these underlying problems with education, assistance and traditional enforcement where appropriate.[60] There is perhaps no better description of the traditional IRS approach to tax collection and the need to reform collection strategy than a statement made by then IRS Commissioner Fred T. Goldberg, Jr. At a Compliance 2000 research seminar, he said:

> We have had what I would describe as a strategy of enforcement that is short-term revenue-maximizing through direct enforcement efforts. It served us well in a lot of respects, and enforcement is essential to what we are doing, but if your theory of tax compliance is essentially to find the highest yielding return, grab that individual, turn him upside down, shake him by the ankles, take the money, put it in the bank, and move on to the next one, that is a terribly short-sighted and I believe counterproductive way of administering the tax laws.[61]

The former Commissioner's point was that IRS enforcement efforts are not compliance driven. Thus, one aspect of Compliance 2000 was the realization that enforcement activities alone cannot keep pace with the increase in filing requirements, taxpayer population growth, and the expansion of the tax gap. The initiative recognized that the cost of one-on-one enforcement is prohibitive as the sole tool for addressing compliance problems. Consequently, alternative strategies need to be developed, particularly for unintentional noncompliance, reserving the most aggressive collection tactics for intentional noncompliance.[62]

Ultimately, the Compliance 2000 efforts did not succeed due to insufficient compliance data and infrastructure to perform market segment research, as well as tensions that arose between district and national research priorities.[63] Ironically, while the IRS abandoned Compliance 2000, the private collection industry has evolved to recognize five important aspects of modern collections theory and practice:

- prompt person-to-person contact with debtors;
- the importance of focusing on the *why* of debtor noncompliance;
- applying the appropriate collections "touch" to the appropriate cause of noncompliance;

[60] General Accounting Office, *IRS Has Made Progress but Major Challenges Remain*, GAO/GGD-96-109, 2-7 (June 1996).

[61] Fred T. Goldberg, Jr., Opening Remarks, November 15, 1990 Research Conference, *Impact of Collection Enforcement Activities on Taxpayer Behavior*, Document 7302 (3-91), 1.

[62] Internal Revenue Service Compliance 2000 Orientation Guide, Document 9102 (7-93), 19.

[63] General Accounting Office, *IRS Has Made Progress but Major Challenges Remain*, GAO/GGD-96-109, 2-7 (June 1996).

- research based approach; and
- preventing opportunities for noncompliance.[64]

It is critical to point out that while IRS tax collectors and private debt collectors have similar responsibilities, such as the collection of revenue at minimum expense, they have very different obligations as well, such as the IRS' duty to ensure that taxpayers are provided with Collection Due Process (CDP) rights.[65] Additionally, private collection agencies are concerned only with maximizing profit on debtor accounts rather than promoting a long-term goal of debtor compliance.[66] Despite these differences, the IRS should employ the successful collection methods of private industry where those methods are consistent with the other functions of the IRS.

Prompt Person-to-Person Contact with Taxpayers

Table 1.14.1 above demonstrates the critical nature that the passage of time plays in the debt collection process. Tax debts that are older than three years are on average nearly uncollectible. The IRS has placed its most valuable tool, i.e. its collection professionals, at the end of the collection process when the value of the account has been severely diminished. In many instances, as time passes and an account gets more delinquent, debtors make critical decisions about their expenditures which cannot be altered by correspondence from creditors.[67] If this type of taxpayer is reached earlier in the collection process by phone, the IRS can affect the taxpayer's willingness to comply, which is beneficial for the IRS and for the taxpayer.[68] The IRS should place a priority on prompt person-to-person contact for delinquent taxpayers. While this approach will entail a reallocation of resources, it can also make better use of existing resources, including the automated predictive dialer systems that efficiently contact taxpayers and automatically transfer calls to trained collection professionals.

[64] Ann McDonald, *Better Connections*, 9 Coll. & Credit Risk, March 2004, 68, noting that modern collections strategy is no longer about "yelling to get dollars," it is about working with willing debtors; *see also* Darren Waggoner, *Not Your Father's Call Center*, 8 Coll. & Credit Risk, September 2003, 46, noting that with cash-strapped debtors in a difficult economy creditors need to be at maximum flexibility to get debtors current; *see also* Peter Lucas, *Building a Better Pipeline*, 9 Coll. & Credit Risk, January 2004, 22, noting a creditor needs to access all pertinent customer information including the why of noncompliance in order to determine the right collection touch for that customer; *see also* Elayne Robertson Demby, *Custom Built*, 9 Coll. & Credit, April 2004, 54, noting that concerns over profitability have caused credit grantors to focus on perfecting custom analytics software to predict which borrowers will default and take steps to prevent default including early intervention and denial of credit.

[65] IRC §§ 6320 and 6330.

[66] For this reason among others, the National Taxpayer Advocate does not favor private collection agencies assuming control of parts of the IRS collection function. *See Collection of Federal Tax Debts by Private Collection Agencies: Hearing Before the House of Representatives Committee on Ways and Means, Subcommittee on Oversight*, 108th Cong., 1st Session (2003) (statement of Nina E. Olson, National Taxpayer Advocate). The American Jobs Creation Act of 2004, H.R. 4520, has now authorized the use of private collection agencies by the IRS. The National Taxpayer Advocate will monitor this development closely.

[67] Darren Waggoner, *Not Your Father's Call Center*, 8 Coll. & Credit Risk, September 2003, 46

[68] Existing IRS policy recognizes that taxpayers can move from a "will pay" category to a "won't pay" category during the delinquency. IRM 5.10.1.4(2).

Finding Out Why Taxpayers Do Not Comply

In this report's companion Examination Strategy analysis, we identified seven types of noncompliance: procedural, lazy, unknowing, asocial, brokered, symbolic and habitual noncompliance.[69] These categories can assist us in understanding the levels of intentional and unintentional noncompliance and can help the IRS apply the appropriate collection strategy depending on the cause of noncompliance. For example, placing a habitually noncompliant taxpayer into the six-month notice stream is likely to have no effect on that taxpayer's compliance, whereas an attempt to seize assets may be the only action that will ever get that taxpayer's attention. In contrast, an inadvertently noncompliant taxpayer will benefit from a notice stream which includes educational information and an offer to discuss the problem person-to-person, rather than threats to seize the taxpayer's assets. In the private collection industry, companies have begun to try to understand why debtors are noncompliant with their payment obligations and have identified similar categories of noncompliance.[70]

In limited circumstances, the IRS collections function takes into consideration the taxpayer's individual circumstances. For example, when a case reaches the Collection Field function and the IRS is considering an asset seizure, revenue officers are required to consider into which of the following categories a taxpayer falls: "will pay," "can't pay," or "won't pay."[71] A

---

[69] *See* this report, Most Serious Problem, Examination Strategy, *infra*; see also Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. Kan. L. Rev. 1145, 1168-1177 (2003), setting forth types of noncompliance: procedural (fails to follow rules), lazy (taxpayer can but does not take action required); unknowing (errors are attributable to ignorance of complex rules); asocial (classic case of tax cheating by individual who feels no obligation to pay taxes); brokered (occurs on the advice of tax professional); symbolic (refusal to pay because of perceived unfairness in the law); social (pattern of social or economic circumstances in which a taxpayer's nonpayment may come from social norm of noncompliance); and habitual noncompliance (where a pattern of noncompliance has developed because earlier attempts at noncompliance were successful).

[70] John Bachman, Ph.D., *The Psychology of Debt*, 6 Coll. & Credit Risk, April 2001, identifying six basic categories of noncompliance, including: imprudent (have no money stored away and live financially one day at a time), naive (ignorant of the consequences of too much debt), fortune's victim (despite adequate planning a catastrophic event causes financial collapse), reckless spender (who spends beyond means), unethical (has no intention to repay debt) and the impoverished (always a high-risk default risk).

[71] IRM 5.10.1.4(1) provides that taxpayers falling into the "will pay" or "can't pay" categories are those taxpayers who:
- Do not agree with the assessment and are working with the Service to properly adjust their account;
- Require a reasonable period of time to sell an asset or secure a loan;
- Qualify for and submit an Offer-in-Compromise;
- Have no ability to make payments and have no distrainable assets (currently not collectible);
- Request and qualify for an installment agreement.

IRM 5.10.1.4(2) provides that taxpayers falling into the "won't pay" categories are those who:
- Have the ability to remain current and/or resolve their delinquent taxes through an alternative collection method but will not do so;
- Taxpayers who do not have the ability to remain current and/or resolve their liability, but who have assets in excess of exempt amounts that will yield net proceeds to apply to the liability and are unwilling or unable to borrow on or liquidate those assets;
- Taxpayers who are pyramiding tax liabilities;
- Taxpayers who use unsupported tax arguments and continue to resist the requirements to file and pay;
- Taxpayers who will not cooperate with the service;
- Taxpayers who will not comply with the results of the Service's financial analysis or will not enter into an installment agreement, or OIC;
- Wage earners who have not paid their tax liability and will not adjust their withholding to prevent future delinquencies;
- Taxpayers who do not meet their commitments (without a valid reason) as set forth by an installment agreement, OIC or extension of time to pay.

seizure of assets should only take place if the taxpayer is in the "won't pay" category.[72] There are three significant aspects of this policy. First, it recognizes that the seizure of assets is an extreme collection tool and should be applied primarily to those taxpayers whose noncompliance is intentional. Second, IRS policy on seizures acknowledges that no case should result automatically in a seizure and that seizures should only occur after a careful weighing of all the facts and circumstances.[73] Third, this policy recognizes that taxpayers move from one category to the next during the life of a tax delinquency, i.e. from a "will pay" to a "won't pay."[74] This acknowledgement is critical since it suggests that with the right contact we can keep the taxpayer in the "will pay" category.

The IRS also encourages Collection Representatives in the ACS to consider whether the taxpayer "will pay," "can't pay" or "won't pay."[75] While the IRS acknowledges that taxpayers can move among the categories of "will pay," "can't pay" and "won't pay," the IRS does not know what types of actions tend to keep taxpayers from slipping into the "won't pay" category because it does not research the *why* of payment noncompliance. Without such knowledge, it is impossible for the IRS to properly train its employees to help taxpayers become compliant while collecting tax debts. Thus, if the IRS is to adopt a modern collection approach, it needs to research and understand how taxpayers react to different collection touches, and train its employees to apply that knowledge toward the long-term goal of taxpayer compliance and not just tax collection.[76]

The Appropriate Collection "Touch"

We have noted that contacts early in the delinquency cycle result in collection of a larger amount of debt. Given that long-term compliance is the tax system's ultimate goal, however, the IRS must ensure that the collection contact pushes the debtor in the right direction.[77] The content of general messages to taxpayers from tax authorities can have a positive impact on compliance.[78] Moreover, the tone utilized by tax authorities can

[72] IRM 5.10.1.4.

[73] IRM 5.10.1.4(3).

[74] IRM 5.10.1.4(2).

[75] IRM 5.19.1.1(3).

[76] The IRS has outstanding research capabilities and can provide answers to questions such as: What types of notices are most effective in the notice stream to induce payment? What is the effect of penalty assessments on taxpayer's willingness to pay? What actions are most likely to cause a taxpayer to move into the "won't pay" category? What are the indirect effects of aggressive collection policies among market segments? What underlying causes of noncompliance respond best to what types of education and outreach?

[77] Ann McDonald, *Better Connections*, 9 Coll. & Credit Risk, March 2004, 68.

[78] Stephen Coleman, *The Minnesota Income Tax Compliance Experiment State Tax Results*, p. 6 (April 1996), finding that letters to taxpayers providing information that rates of tax cheating are actually lower than commonly believed resulted in higher payments of tax.

affect compliance.[79] For example, the IRS often sends a first notice followed by progressively sterner correspondence. The subsequent notices are sent out automatically without taking into account any actions the taxpayers have taken, or communications they have had with collection agents.[80] The IRS also utilizes sanctions to compel tax compliance;[81] however, sanctions as a tool against noncompliance may actually undermine compliance.[82] The IRS needs to research and understand what types of communications and actions facilitate tax compliance.

When the IRS knows what types of communications facilitate tax compliance, it can target its collection strategies more appropriately. While the IRS is now using risk based determinants to establish which cases should be worked and which cases should be shelved,[83] it does not use customized analytics to decide which strategies will suit different taxpayers, though such software is commercially available.[84] By failing to establish collection strategy alternatives depending on the types of noncompliance, the IRS is handicapping itself from addressing those taxpayers who might individually score as a low collection priority but who in the aggregate with other similarly situated taxpayers are significant contributors to the tax gap.

An example of a taxpayer who may score low in a collection risk model is a sole proprietor with a relatively small delinquency. The amount of unreported and underreported income tax attributable to individual taxpayers engaged in trades or businesses is approximately $81.2 billion dollars and constitutes the single largest component of the gross tax gap.[85] Sole proprietors who are compliant with their filing obligations file Schedule C (Profit or Loss from Business). Schedule C filers are not subject to income tax withholding and are only subject to information reporting above a certain

[79] See Michael Wenzel, Centre for Tax System Integrity, *Principles of Procedural Fairness in Reminder Letters: An Experimental Study*, 5 (Working Paper No. 42, Dec. 2002) at http://ctsi.anu.edu.au/UP.Wenzel.reminder.doc, concluding that the tone of letters may affect taxpayer compliance.

[80] Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 U. Kan. L. Rev. 971, 1005 (2003).

[81] *See as examples*: IRC § 6662, assessing penalties for accuracy related noncompliance; IRC § 6661, assessing penalty for understatement of tax; and IRC § 6651, assessing failure to file and pay penalties.

[82] Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L. J. 1453, 1461 (2003).

[83] Treasury Inspector General for Tax Administration, *The New Risk Based Collection Initiative Has the Potential to Increase Revenue and Improve Future Collection Design Enhancement*, Reference No. 2004-30-165, 2 (September 2004).

[84] Lois Brown, *Making the Right Collections Calls, 8 Coll. & Credit Risk*, March 2003, indicating that in order to recoup millions of dollars of uncollected revenues many financial institutions are supplementing behavioral based scoring with action-specific modeling solutions that predict responses to particular actions, such as sending a letter versus making a collection call. Action based analytics help creditors tailor collection actions to fit the debtor by using all available information about the debtor, including payment history, calls, promises made, promises kept, geography, delinquency history and many other factors.

[85] *See* IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (Feb. 24, 2004).

threshold.[86] Random taxpayer audits have consistently shown higher compliance rates among income items subject to third-party withholding and reporting requirements.[87] Schedule C taxpayers also account for 58.6 percent of total dollars due from individual non-filers, representing a balance due of $15.9 billion.[88] When a class of taxpayer constitutes such a significant contributor to the tax gap, the IRS needs to consider incorporating the taxpayer classification into the risk based criteria used to decide priority among cases to be worked.

Research Based Approach

Throughout this analysis, we have identified information that the IRS needs in order to employ a modern collection strategy, which includes tailoring collection strategies to fit the different causes of noncompliance.[89] We have demonstrated that a farsighted compliance based collection strategy implies understanding the effects of collection strategies on taxpayers whose noncompliance stems from different causal factors. The IRS needs to research the effect of its collection actions on taxpayers in order to help it establish these collection strategies. While most collection professionals agree that optimum collection tactics will vary depending on a range of criteria, such as payment behavior, payment frequency and payment ability, they also acknowledge that research is the key to developing these collection strategies.[90]

Reducing Opportunities for Payment Non-Compliance

With improvements to the collection process and a compliance-based collection strategy, the IRS can reduce the tax gap and increase compliance. However, the IRS would need to rely less on its collection function if it could reduce the opportunities for noncompliance. Researchers have concluded that noncompliance with the tax laws has proven to be highest where the opportunity for noncompliance is greatest.[91] This fact suggests a strate-

[86] IRC §§ 6041A and 6050A require information returns (Forms 1099) to be filed if any service recipient in a trade or business pays to the service provider in the course of such trade or business during any calendar year the aggregate of $600 or more.

[87] Kim M. Bloomquist, *Tax Evasion, Income Inequality and Opportunity Costs of Compliance*, 96th Annual Conference on Taxation, 2 (Nov. 2003).

[88] Internal Revenue Service, *Compliance Risk Assessment Document, FY 04-05 Strategic Planning Cycle*, 47.

[89] In the Examination Strategy piece above, we emphasized the need for research into the indirect effects of audits within a market segment so that limited exam resources can be maximized. *See* Most Serious Problem, Examination Strategy, *infra*. The same research needs to be conducted into whether there are similar indirect effects within market segments based on the IRS collection strategy.

[90] Karl Boone and Ian Roberts, *A Formula for Success*, 9 Coll. & Credit Risk, February 2004.

[91] Alan H. Plumley and C. Eugene Steuerle, *The Crisis in Tax Administration, Ultimate Objectives for the IRS: Balancing Revenue and Service*, 311, 314.

gy which emphasizes removing opportunities for noncompliance. Because compliance approaches 100 percent when adequate provisions for withholding are made under withholding laws, this strategy should include strengthening and expanding tax withholding programs. The National Taxpayer Advocate again advocates this year for the expansion of withholding requirements into the area of federal contracting.[92]

CONCLUSION

In this analysis, we identified flaws in the IRS collection process which are both strategic and structural in nature. Strategically, the IRS has emphasized direct enforcement efforts without an appropriate emphasis on the future tax compliance of taxpayers. Structurally, the IRS has not designed a collection function which takes advantage of sound modern collections practice, such as emphasizing prompt person-to-person contact with delinquent taxpayers. The IRS does not target collection strategies to fit the causes of noncompliance and does not research which collection strategies will have the desired impact on different taxpayers. The problems with the IRS collection strategy predated RRA 98 and contributed to the expansion of the tax gap long before the enactment of RRA 98.

We have suggested a multifaceted approach that would harmonize a modern collection strategy with an emphasis on tax compliance. This approach includes a reallocation of resources to make person-to-person contacts early on in the collection process. When the IRS makes these contacts, it should tailor its contacts with the taxpayer towards the causes of noncompliance and employ the most appropriate collection strategy for that taxpayer. Moreover, the IRS should take all possible steps to remove opportunities for payment noncompliance.[93]

IRS COMMENTS

The Internal Revenue Service (IRS) agrees that the tax gap is a serious problem, and we are taking actions to improve the IRS's collection program. We also agree with the general message that the Service could benefit from a "modernized" collection process and are committed to conducting an ongoing analysis of our structure to ensure maximum organizational efficiency, effectiveness, and customer service. The IRS SBSE Compliance organizations have recently realigned along functional lines. Now, Collection executives, managers, and employees, with functional expertise and knowledge, are working within one organization to best meet the needs of taxpayers. We believe this new structure will provide increased opportunities for issue identification and process improvements within the Collection program.

[92] *See* Key Legislative Recommendation, *infra*.

[93] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 256.

The scope of the problem involving unpaid taxes is large and complex. In the report, the National Taxpayer Advocate identified several aspects of modern collections theory and practice, such as prompt person-to-person contact with debtors, focusing on the "why" of debtor noncompliance, and applying the appropriate collection "touch" to the cause of noncompliance. We agree that these aspects are important in an effective collection program. However, our efforts, both past and current, to address these aspects have been constrained by budget, resource, legislative, and technology limitations.

Once an assessment is made, the IRS attempts to collect the amount due in the most efficient manner. The IRS contacts taxpayers through notices and phone calls before utilizing enforcement treatments. If the taxpayer chooses not to interact with IRS, enforcement may be pursued. Given certain legal notification requirements, coupled with limited IRS collection resources, it is not economically feasible to attempt face-to-face contact as an early treatment. Although early personal contact would be ideal for identifying the reasons for the delinquency at hand and going beyond that to foster future compliance, we must use our limited resources to address the most egregious cases, which are usually those who do not respond to the early phone calls.

The IRS continues to conduct research on the causes of noncompliance to understand what drives delinquent taxpayers' behavior. There are many human motivations, personal preferences, and business decisions that drive such behavior; understanding these different behaviors can be complex and costly. Based on the analysis of numerous studies, using alternative treatments and educational outreach targeted to specific populations, IRS has made changes in its collection case selection and processing criteria. Additional research projects are underway to better understand why taxpayers do not file and do not pay, so that additional alternative treatments can be developed. In addition, Collection employees are required to address the cause of a delinquency and to conduct a full compliance check on all delinquent accounts.

As the IRS has continued to enhance its collection strategy, we have implemented several initiatives to deter the growth of accounts receivable and to maximize our effectiveness in identifying and collecting unpaid taxes. Recent performance indicators show that these efforts are having a positive impact on compliance. In January 2003, the IRS began using collection models to identify accounts likely to be full paid or currently not collectible, with the intent to direct resources to those cases deemed to be more collectible. The Federal Tax Deposit (FTD) Alert system was enhanced in 2004 to more accurately detect in-business accounts where tax deposits have fallen behind. The system's new criteria are expected to reduce the number of nonproductive FTD alerts and free valuable resources to work delinquent accounts in a more proactive manner.

The Federal Payment Levy Program was expanded to more efficiently address Federal contractor noncompliance. In addition, legislation was enacted in November 2004 to allow the IRS to proceed with the Collection Contracting Support project. This new provision recognizes that the IRS will benefit from the assistance of outside contractors in collecting outstanding taxes.

The IRS also continues to expand its pre-filing activities, especially in stakeholder and taxpayer partnership programs. We encourage new and innovative ways to increase taxpayer compliance through more effective communication and outreach before returns are prepared and filed. Examples of such initiatives include penalty relief to promote compliance and improved websites to assist taxpayers and to promote IRS messages.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate is pleased that the IRS acknowledges that the "why" of debtor noncompliance and applying the appropriate collections "touch" are important components of an effective collection strategy. We also appreciate the role that limited resources play in the establishment of a comprehensive collection strategy. The problem of scarce resources prevents the IRS from more effectively addressing the twin threats to our nation's tax administration system: the growing tax gap and the erosion of tax compliance. However, the problem of scarce resources does not mean that the IRS should not address the strategic and structural flaws in its collection strategy. In fact, resource limitations may make the need to address those flaws more acute.

In its response, the IRS indicates that face-to-face contact is cost prohibitive and ought to be reserved for the most egregious noncompliant taxpayers, and we agree. However, person-to-person contact via telephone is efficiently and effectively utilized by the private collection industry through predictive dialer systems. Once debtors are reached by telephone, private creditors advocate reasons why the debtor should return to compliance with that creditor. The IRS cannot cede this important opportunity to communicate with delinquent taxpayers early on in the process. The IRS needs to take the initiative to call delinquent taxpayers and not wait for them to call. Once communication is established, the IRS can:

- *Advocate the important reasons why taxpayers should remain compliant in their obligations to the Federal government;*
- *Understand the causes of noncompliance; and*
- *Tailor the collection strategy to fit the cause of noncompliance.*

As technologies change and taxpayers become more reliant on cell phones and alternative means of communication, some taxpayers may become harder to contact. Other taxpayers will continue to avoid IRS initiated contact. Thus, vigorous local enforcement initiatives will remain vital to the IRS collection effort. The Failure to Deposit Alert system described in the IRS response is a positive example of attempting to reach noncompliant taxpayers faster.

Throughout its collection efforts, the IRS' collection strategy must remain consistent with the overall goal of tax compliance and take into consideration the collection due process rights of taxpayers. Implementing a modern tax collection strategy requires resources, taxpayer information, trained professionals, and complex information systems. The IRS is best suited to this task, although it will require a reallocation of resources in order to focus not just on today's delinquent tax dollars but also on tomorrow's tax obligations.

PROBLEM TOPIC D-16

MOST SERIOUS PROBLEM: FEDERAL CONTRACTORS AND THE FEDERAL PAYMENT LEVY PROGRAM

RESPONSIBLE OFFICIALS

John M. Dalrymple, Deputy Commissioner for Operations Support
Kevin M. Brown, Commissioner, Small Business/Self Employed Division
Henry O. Lamar, Jr., Commissioner, Wage and Investment Division
Steven T. Miller, Commissioner, Tax Exempt and Government Entities

DEFINITION OF PROBLEM

In February 2004, the General Accounting Office (GAO)[1] found that in 2002, more than 27,000 Department of Defense (DOD) contractors owed about $3 billion in unpaid federal taxes and many contractors with outstanding liabilities continued to receive federal contract awards and payments.[2] The National Taxpayer Advocate believes Federal contractor noncompliance is among the most serious problems facing taxpayers because it contributes to the growing federal tax gap,[3] and thus forces law-abiding taxpayers to subsidize these contract awards by making up for the resulting revenue shortfall. This noncompliance also places law-abiding contractors at an unfair competitive disadvantage because nonpaying contractors can use their "tax savings" to underbid compliant ones. There is an inherent unfairness when those who "reap the benefits of Federal contracts" refuse to fulfill their federal tax obligations.[4]

The IRS and other responsible agencies are not effectively administering the law or procedures meant to remedy this problem. The Internal Revenue Code requires federal agencies to report both contract awards and payments to the IRS, and provides a mechanism for automatically collecting outstanding taxes from payments. However, there are numerous deficiencies in both reporting and collection, including errors in information reported on required forms; abundant missteps in form processing (including the IRS having no record of required forms being filed after the 2001 tax year and failing to associate information on various required forms to identify noncompliance), and underutilization of the automated federal payment collection system.

1 Now the Government Accountability Office.

2 GAO Report to Congressional Requesters, *DOD Pays Billions of Dollars to Contractors That Abuse the Federal Tax System*, GAO-04-95, 3 (Feb. 2004). The GAO report concerned only DOD contractor tax liabilities. *Id.* at 2. The total amount of unpaid taxes for all federal contractors is not known *Id.* at 9. Non-DOD federal contractors accounted for 34 percent of total federal contract awards in 2002. *Id* at 7. GAO looked at only one DOD database, thus the reported 27,000 contractors is likely only a fraction of defense contractors with outstanding Federal tax liabilities *Id.* at 21.

3 *See* Key Legislative Recommendation, Tax Gap Provisions, *infra*.

4 H.R. Rep. No. 426, 99th Congress, 1st Sess. 855 (1985), 1986-3 (Vol. 2) C.B. 855 (legislative history of Internal Revenue Code section 6050M).

ANALYSIS OF PROBLEM

Current Law

The IRC requires federal agencies to report information about contract awards and contract payments to the IRS. Section 6050M of the Code provides that the head of every federal agency who enters into certain contracts shall make a return reporting information for contracts greater than $25,000 on Form 8596 (Information Return for Federal Contracts) and Form 8596-A (Quarterly Transmittal of Information Returns for Federal Contracts).[5] The required information includes the contractor's name, address and Taxpayer Identification Number (TIN); the contract date and expected completion date; and the total contract obligation amount.[6]

Congress added § 6050M to the Code to prevent contractors from "reap[ing] the benefits of Federal contracts" without fulfilling tax obligations.[7] The information returns were designed to facilitate the collection of delinquent taxes by notifying the IRS of a source for collection.[8] The contractor's TIN and name combination reported on Form 8596 is used to associate information returns with corresponding information on tax returns.[9]

The Code also requires federal agencies to report payments to contractors.[10] Section 6041A(a) requires service recipients to report payments of $600 or more on Form 1099-MISC. Federal agencies must file this form to report payments to both individuals and corporations.[11]

When a Federal contractor[12] has an outstanding tax liability, IRC § 6331(h) allows the IRS

---

5 No information return is required for: any contract of $25,000 or less; any contract with a contractor who is acting in his or her capacity as an employee of a federal executive agency; any contract between a federal executive agency and another federal government unit; any contract with a foreign government; any contract with a state or local government unit; any contract with a person who is not required to have a TIN; any contract whose terms provide that all amounts will be paid on or before the 120th day following the date of the contract action; any contract under which all money (or other property) that will be received by the contractor after the 120th day after the date of the contract action will come from persons other than a federal executive agency or an agent of such an agency (e.g., a contract under which the contractor will collect amounts owed to a federal executive agency by the agency's debtor and will remit to the agency the money collected less an amount that serves as the contractor's consideration under the contract); or any contract for which the IRS determines that information described in Treas. Reg. § 1.6050M-1 will not facilitate the collection of federal tax liabilities because of the manner, method, or timing of payment by the agency under that contract. Treas. Reg. § 1.6050M-1(c)(1) and (d).

6 Treas. Reg. § 1.6050M-1(a). And, if the contractor is a member of an affiliated group of corporations that files its Federal income tax returns on a consolidated basis, the name and TIN of the common parent of the affiliated group. IRC § 7701(a)(41) defines the term "TIN" as meaning the identifying number assigned to a person under IRC § 6109.

7 H.R. Rep. No. 426, 99th Congress, 1st Sess. 855 (1985), 1986-3 (Vol. 2) C.B. 855, (legislative history of Internal Revenue Code section 6050M)

8 *Id.*

9 Rev. Proc. 99-9, 1999-2 I.R.B. 17 Section 10.02.

10 Or any service providers.

11 IRC § 6041A(d)(3)(A). Service recipients that are not federal agencies generally do not have to report payments to corporations on Form 1099-MISC.

12 Or any taxpayer receiving federal payments.

to continuously levy up to 15 percent of Federal payments to the contractor.[13] This continuous levy system, the Federal Payment Levy Program (FPLP), began operating in July 2000. The FPLP was designed to ease the administrative burdens of collecting taxes by levy.[14] With Form 8596 requiring federal agencies to report contract awards to the IRS, Form 1099-MISC requiring agencies to report payments to contractors, and the FPLP allowing the IRS to levy on payments to delinquent or non-compliant contractors, it would seem that Congress has given the IRS the necessary tools to remedy federal contractor tax avoidance. The IRS, however, is not using these tools effectively. The problems in the administration of Forms 8596 and 1099-MISC and the FPLP are numerous.

Form 8596 - Information Return for Federal Contracts

Filing Procedures

Depending on specific circumstances, federal agencies can file Forms 8596 and 8596-A via magnetic media,[15] on paper,[16] or have the Federal Procurement Data Center (FPDC) file forms on the agency's behalf.[17]

Magnetic Media

Federal agencies expecting to enter into 250 or more reportable contracts during a one-year period beginning October 1 must file Forms 8596 on magnetic media for each quarter of that period. Agencies entering into fewer than 250 reportable contracts are not required to file on magnetic media but may choose to do so.[18]

Paper Filing

Federal agencies that expect to enter into fewer than 250 reportable contracts are directed to mail their Forms 8596 and 8596-A to the IRS center in Kansas City, Missouri.[19] There, the forms are to be verified, photocopied, and hand delivered to the Integrated

[13] Unless the eligibility for the payments are based on the payee's income and/or assets. IRC § 6331(h)(2). The American Jobs Creation Act of 2004, P.L. 108-357, effective October 22, 2004, amended IRC § 6331(h) to allow the IRS to levy up to 100 percent of specified payments due to vendors of goods or services sold or leased to the Federal Government. IRC § 6331(h)(3). The Joint Committee on Taxation expressed some concerns with this new provision. Specifically that it "might discourage vendors who owe amounts to the IRS from selling goods or services to the Federal government," and that it could lead to the bankruptcy of Federal contractors who have substantial business with the Federal Government. Staff of the Joint Comm. On Tax'n, 108th Cong., Description of Revenue Provisions Contained in the President's Fiscal Year 2005 Budget Proposal 341 (Comm. Print 2004).

[14] Revenue Reconciliation Act of 1997, Pub. L. No. 105-34 as explained in the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97) (Dec. 17, 1997), 216.

[15] Treas. Reg. § 1.6050M-1(d)(3) includes Magnetic media as a filing option. Magnetic Media is any disk, tape, cartridge, diskette, cassette or other devise that is used to store data.

[16] Treas. Reg. § 1.6050M-1(d)(3)(ii) and Form 8596 instructions advise taxpayers to mail forms to the Internal Revenue Service Center, Kansas City, MO. 64999-222

[17] Treas. Reg. § 1.6050M-1(d)(5).

[18] Treas. Reg. § 1.6050M-1(d(2).

[19] Rev. Proc. 99-9, 1999-2 I.R.B. 17, § 11.

Submission and Remittance Processing (ISRP) Area for computer data input.[20] However, the program used to convert paper information to an electronic format will not accept Forms 8596 and 8596A. Thus, the IRS center is unable to process paper forms.

FPDC Election

The FPDC, which is part of the General Services Administration (GSA), operates and maintains the Federal Procurement Data System (FPDS) – the central repository of statistical information on Federal contracting.[21] This system contains detailed information on all contract actions over $25,000 and summary data on procurements of less than $25,000. Federal agencies that are required to submit contract information to both the FPDC and the IRS may elect to have the FPDC file Forms 8596 and 8596-A on their behalf.[22]

Problems With Form 8596

The Case of the Missing Forms

The main problem with Form 8596 is that it seems to have disappeared in the IRS system after the 2001 tax year. Federal agencies have been required to file Forms 8596 since January 1, 1987.[23] Startlingly, however, the IRS has no record that any Forms 8596 have been filed since tax year 2001.[24] Nor are there records to indicate that the IRS itself filed any required Forms 8596 for IRS contracts entered into after the 2001 tax year.[25] Table 1.16.1 presents the history of Form 8596 receipts from the 2001 tax year forward.[26]

TABLE 1.16.1, FORM 8596 RECEIPTS

Tax Year	Received Electronically from FPDC	Paper Forms Mailed to KCSC	Filed on Magnetic Media
2001	316,703	0	0
2002	0	0	0
2003	0	0	0

[20] IRM 3.24.8, Information Return Processing, ISRP System, does not contain instructions for entering and verifying data.

[21] In 2003, GSA awarded a contract to Global Computer Enterprises, Inc. for the design, development, operation and maintenance of the Federal Procurement Data System-Next Generation (FPDS-NG). Beginning October 1, 2004 Global Computer Enterprises, Inc. is the owner and operator of the FPDS-NG. FY 2004 Federal contract information is being reported in the FPDS-NG system.

[22] Rev. Proc. 99-9, 1999-2 I.R.B. 17, § 5. The Rev. Proc. does not address procedures for transmitting the election when the FPDC files electronically. In 2002, the last year the FPDC filed Forms 8596, the returns were filed electronically.

[23] Pub. L. No. 99-514 § 1522(a) added § 6050M effective for contracts (and subcontracts) entered into, and licenses granted, before, on, or after Jan. 1, 1987. The Reg. 1.6050M-1(f)(1) became effective on Jan. 1 1989.

[24] E-mail from IRS Modernization and Information Technology Services (MITS) Specialist (Policy & Planning) received on Aug. 11, 2004.

[25] IRS has elected to have GSA report Form 8596 information via FDPS. Agency-Wide Shared Services, Sept. 1, 2004.

[26] E-mail from IRS Modernization and Information Technology Services (MITS) Specialist (Policy & Planning) received on Aug. 11, 2004.

This missing information is not insignificant. In fiscal years 2002 and 2003, Federal executive departments and agencies granted nearly $525 billion in Federal contract actions.[27] The Forms 8596 reporting this $525 billion are nowhere to be found.

What happened? What became of these forms that are required by law to be filed with the IRS? This mystery has yet to be solved, but three clues may serve as a starting point for investigation.

The first clue is that it is unclear who, if anyone, in the IRS was responsible for Form 8596 until sometime in 2004. The Office of Federal, State and Local Governments (FSLG) in the Tax Exempt/Government Entities (TE/GE) operating division recently discovered it had ownership of Form 8596 after the Forms and Publications office asked FSLG if it wanted to revise Form 8596, since it had not been revised since 1999.[28] The Taxpayer Advocate Service has not been able to find out which IRS division "owned" these forms before FSLG assumed responsibility in 2004. One explanation could be that the program was lost when the IRS was restructured by the Internal Revenue Service Restructuring and Reform Act of 1998.[29] Since becoming aware of its responsibility for Form 8596, FSLG has attempted to work with the IRS' Modernization and Information Technology Services (MITS) function and the FPDC to discover why the IRS has no records of any Form 8596 filings since the 2001 tax year. So far, FSLG has not reached a determinative conclusion about the missing forms, or even whether the error lies with the IRS or FPDC.[30]

In fact, the second clue is that the problem may lie with the FPDC and not the IRS. So far, FSLG has determined: (1) most federal agencies elect to have the FPDC file Forms 8596 on their behalf,[31] and (2) the IRS has no record of any Form 8596 transmissions from FPDC for more than 11 quarters (i.e., since the 2001 tax year).[32] FSLG is still trying to determine whether the FPDC did not transmit any Forms 8596 for those 11 quarters or if the IRS did not receive or record transmissions.[33]

[27] Information posted to the Federal Procurement Data Center (FPDC) Website, http://www.fpdc.gov. According to this website, a "contract action" is any "obligation or deobligation of funds." Approximately 60 Executive Branch agencies report procurement contract actions to the FPDC. Thus the $525 billion represents the net obligation and deobligation amount for these agencies for fiscal years 2002 and 2003.

[28] Telephone conversation with the FSLG Field Operations Coordinator on Aug. 3, 2004.

[29] Pub. L. No. 105-206 (July 22 1998).

[30] Information provided by FSLG Field Operations Coordinator in an e-mail received Oct. 25, 2004.

[31] Approximately 60 executive branch agencies report their procurement contract obligations to the FPDC. The largest exception to the requirement to report is the U.S. Postal Service. The legislative branch (Congress) and the judicial branch (U.S. Courts) do not report to the FPDC. State and local governments do not report their contracts to the FPDC. Source: FPDC website at http://www.fpdc.gov. .

[32] E-mail from TEGE/FSLG program analyst received on August 24, 2004.

[33] Transmissions for the four quarters of FY 2002 and FY2003, plus the first, second, and third quarters of FY 2004. Source: E-mail from TEGE/FSLG program analyst received on Aug. 24, 2004.

The third, and most insightful, clue is that the IRS and FPDC computer systems may not be compatible. The IRS system that is meant to receive Form 8596 transmissions from the FPDC employs outmoded languages and technology that are not generally used in today's web-based environment. FSLG and the FPDC discovered this incompatibility when attempting to arrange the transmission of Forms 8596 due on October 31, 2004. As a result, the FPDC will begin to develop a program that is compatible with the IRS system.[34] The FPDC estimates this program will be ready no earlier than February 2005. This will be too late for the January 31, 2005 filing date, but the FPDC hopes to transmit Form 8596 information for all missing quarters when it has a program compatible with IRS computer systems.[35]

Inaccurate Information

Not only is the IRS missing any and all Forms 8596 filed since tax year 2001, but the information on the forms the IRS has received is suspect. According to MITS, the Forms 8596 submitted electronically by the FPDC for 2001 appear to contain incorrect amounts.[36] The Taxpayer Advocate Service understands that the IRS contacted the FPDC three separate times to request a corrected replacement file which the FPDC never sent and instead instructed the IRS to process the original submission. Thus, even the Form 8596 information from 2001 that the IRS does possess is not useful.

The IRS is not alone in questioning the accuracy of FPDS data. The GAO expressed "serious and continuing" concerns about FPDS reliability to the Office of Management and Budget (OMB) in December 2003.[37]

Repeating the past

Interestingly, the problems with Form 8596 are not new. The House of Representatives Committee on Ways and Means held a hearing on problems with federal contractor information reporting in March 1992. The problems discussed at that hearing are nearly identical to those of today. In 1992, more than 5,700 Federal contractors owed in excess of $770 million in taxes, interest and penalties; 536 Federal contractors had simultaneous contract payments and tax delinquencies; and almost 1,100 taxpayers with Federal con-

[34] This program will be developed by the FPDC's contractor, Global Computer Enterprises. *See supra*.

[35] FSLG Outreach Planning and Review Monthly Briefing, Oct. 2004. It is also notable that the United States Postal Service (USPS), who does not file its Forms 8596 through the FPDC, made an electronic Form 8596 submission to the IRS in June 2004. The IRS, however, could not process this submission because it was in a format that was not compatible with the IRS system. The IRS has requested a replacement submission from the USPS. FSLG Outreach Planning and Review Monthly Briefing, Oct. 2004.

[36] According to the IRS Modernization & Information Technology Services, examples of suspected inaccurate data included a $117.94 total contract obligation amount and a total contract amount for one federal agency of $328.59.

[37] GAO, *Reliability of Federal Procurement Data*, GAO-04-295R (Dec. 2003). The GAO recommended that the Director of OMB request that major agencies, in consultation with GSA, conduct regular reviews of their procedures for collecting and reporting information to the next generation FPDS (FPDS-NG). On October 1, 2004, Federal agencies began entering contract information on the FPDS-NG system.

tracts were under investigation for failing to file Federal tax returns.[38] A GAO representative testified that, despite the 1986 Tax Reform Act requiring federal agencies to report information on federal contracts, the IRS had not developed procedures to fully use the information received from these agencies and had no procedure to ensure that all required information was properly reported.[39] The GAO representative also recommended that the IRS "establish a mechanism to ensure that federal agencies and FPDC report all required information on federal contract actions."[40]

At this hearing, the Deputy Commissioner of Internal Revenue recognized the problems and presented ways that the IRS could increase and improve its use of Form 8596 data. The Deputy Commissioner also committed the IRS to perform "a regular Federal contractor match against the entire accounts receivable and currently-not-collectible inventories to ensure that those who benefit from Federal contracts also meet their delinquent tax obligations."[41] As the current problems demonstrate, the IRS has yet to follow through on these 1992 commitments.

Form 1099-MISC

The IRS uses the information on Forms 1099-MISC to identify non-filers and taxpayers who do not report all of their income on filed returns. The IRS enters Form 1099-MISC information into two databases: (1) the Payer Master File (PMF)[42] and (2) the Information Returns Master File (IRMF).[43]

The IRS enters basic information into a temporary database when a Form 1099-MISC is received, comparing the payee TIN/name combination with TIN/name combinations in IRS records. If it matches, the information is entered in the IRMF. If there is no match,

[38] Delinquency information was extracted from IRS' business master file on July 31, 1991. GAO used the information to determine the amounts of taxes due and to identify accounts where returns had not been filed. General Accounting Office (now known as the Government Accountability Office), Testimony Before the Subcommittee on Oversight, Committee on Ways and Means House of Representatives, *Federal Contractor Tax Delinquencies and Status of the 1992 Tax Return Filing Season*, GAO/T-GGD-92-23, 3 (March 17, 1992).

[39] IRC § 6050M which was added by section 1522 of the Tax Reform Act of 1986 (Pub. L. No. 99-514) and amended by section 1015(f) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647) requires Federal Executive Agencies to file an information return with the IRS reporting the name, address and TIN of each person and/or corporation with whom the agency enters into a contract.

[40] General Accounting Office (now known as the Government Accountability Office), Testimony Before the Subcommittee on Oversight, Committee on Ways and Means House of Representatives, *Federal Contractor Tax Delinquencies and Status of the 1992 Tax Return Filing Season*, GAO/T-GGD-92-23 (March 17, 1992).

[41] Statement of Michael P. Dolan, Deputy Commissioner of Internal Revenue, before the Subcommittee on Oversight, House Committee on Ways and Means (March 17, 1992), 15.

[42] The PMF is a database that includes all entities that make payments subject to information return reporting and includes general information on the total number and dollar value of information returns, including Forms 1099-MISC, filed by each payer for each year. GAO Report to Congressional Requesters, *More Can be Done to Ensure Federal Agencies File Accurate Information Returns*, GAO-04-74, 5 (Dec. 2003).

[43] The IRMF is a database that includes specific information on the type and amount of payments made to each payee, including whether the payee TIN was valid upon receipt of the information return, and if the TIN was invalid, whether IRS subsequently corrected it. GAO Report to Congressional Requesters, *More Can be Done to Ensure Federal Agencies File Accurate Information Returns*, GAO-04-74, 5 (Dec. 2003).

the IRS attempts to validate the TIN/name combination.[44]

1099-MISC information is also entered into the Information Returns Program (IRP). IRP information is matched against individual income tax return information to determine if an individual who received a payment reported on a 1099-MISC reported this payment as income on his or her return.[45] IRP information is not, however, matched against returns for business entities such as corporations, partnerships and trusts.[46]

Problems with Federal Contractor Form 1099 Reporting

The problems with Federal contract information reporting do not stop with Form 8596 but extend to Form 1099-MISC reporting as well. In December 2003, the GAO reported that in tax years 2000 and 2001, approximately 152,000 information returns for Federal payments totaling about $5 billion were not filed with the IRS. Meanwhile, about 170,000 information returns including $20 billion in Federal payments reported invalid TINS. According to IRS records, about 8,800 of these payees, who collectively received payments totaling about $421 million dollars, failed to file tax returns for these two years. The GAO report also noted that few agencies take advantage of IRS's TIN-Matching program to validate vendor TINS before submitting information returns to the IRS.[47]

The IRS does not match the information reported on Forms 8596 against information on Forms 1099-MISC. This is because: (1) Form 8596 reports total contract obligations, while Form 1099-MISC reports amounts actually paid during a particular tax year;[48] and (2) Form 1099-MISC shows only the total payments to a specific service provider, not the payments attributable to a particular contract. The IRS could, however, link or associate the information on these two forms to determine 1099-MISC and return filing compli-

[44] TIN Validation takes all the reformatted records containing all-numeric TINs and attempts to validate them against the source master files of TIN/Name Control combinations. The source files used in this validation are the DM-1 File and the EIN/Name Control File. The DM-1 file is provided by the Social Security Administration (SSA) and contains all Social Security Numbers (SSNs) issued, along with their associated name controls. The EIN/Name Control file contains all EINs in use since 1984 or issued by IRS since 1984. This list is developed based on extracts from the Business Master File (BMF) and Employee Plans Master File (EPMF). All valid documents go to the IRMF. Any invalid TIN documents go to TIN Perfection. The only documents that go through the TIN Perfection process are those containing invalid TINs (TINs which were not validated during TIN Validation), blank TINs, all zero TINs, or TINs with less than nine numerical characters. IRM 4.6.1.6.4 and 5.

[45] IRM 4.6.1.6.8.1 "The information returns profiles for the current primary and secondary files are matched to Individual Master File account data for the respective returns."

[46] IRM 4.6.1, Examining Process, Payer Compliance, Information Returns Program (IRP) is silent on matching information to Business Master File account data.

[47] GAO Report to Congressional Requesters, *More Can be Done to Ensure Federal Agencies File Accurate Information Returns*, GAO-04-74, 7 (Dec. 2003).

[48] Revenue Ruling 2003-66 clarifies that sections 6041A and 6050M impose separate information reporting requirements and have different underlying purposes. The purpose of IRC § 6041A is to identify unreported income, according to S. Rep. No. 494, 97th Cong. 2d Sess. 247 (1982), July 12, 1982 (Senate Report) and the purpose of IRC § 6050 is to provide the IRS with information concerning sources from which it can collect delinquent taxes owed by Federal contractors, according to H.R. Rep. No. 426, 99th Congress, 1st Sess. 855 (1985), 1986-3 (Vol.2) C.B. 855

ance, and identify future income sources for any necessary levies.[49]

Obviously, there is no current Form 8596 and 1099-MISC association because the IRS has not received any Forms 8596 since the end of 2001. But it also appears that the IRS has never had a program in place to associate the information on these forms even when Forms 8596 were being received. In researching this problem, TAS found no record of any Form 8596/Form 1099-MISC linking or association program since Form 8596 has been required (January 1, 1987). Because information from both forms was reported on the IRMF, individual revenue agents could have done independent information association for taxpayers whose accounts they examined, but there is no evidence of any IRS-wide program.

Another problem is that Forms 1099-MISC are not matched with income tax returns filed by business entities. One reason business returns are not matched to Forms 1099-MISC is that service recipients are generally not required to issue a Form 1099-MISC to a corporate service provider.[50] There is an exception to this rule, however, for Federal contactors. Federal agencies are required to issue a Form 1099-MISC to all Federal contractors, including corporations.[51] Thus, the IRS is not using existing and available information to determine whether corporate Federal contractors are reporting income from Federal contract payments. And these payments are significant.

In fiscal years 2001, 2002 and 2003, Federal agencies awarded contracts worth over $215 billion, $234 billion and $290 billion, respectively.[54] In FY 2001, the "Top 100 Federal Contractors" were all corporate entities.[55] In FY 2002, more than 70 Top Federal Contractors were corporations; and in FY 2003, 90 of the Top 100 were corporations.[54]

Interestingly, in September 2002, the Treasury Inspector General for Tax Administration (TIGTA) recommended that the IRS evaluate the feasibility of matching business information returns with business tax returns.[55] A recent SB/SE study of this issue recommended that the IRS develop and implement a business income-matching compliance program, but only for business nonfilers.[56]

[49] The IRS could check Forms 8596 against Forms 1099-MISC to determine if Federal agencies were filing and issuing Forms 1099-MISC against the listed contractors' tax returns for both filing and reporting compliance.

[50] Treas. Reg. § 1.6041-3(p)(1).

[51] IRC § 6041(A)(d)(3).

[52] Federal Procurement Data Center (FPDC) website, http://www.fpdc.gov.

[53] The Top 100 Federal Contractors are the 100 Federal contractors receiving the highest percentage of total contract dollars awarded during a fiscal year. Federal Procurement Data Center (FPDC) website, http://www.fpdc.gov.

[54] *Id.*

[55] Treasury Inspector General for Tax Administration (TIGTA), *The Internal Revenue Service Should Evaluate the Feasibility of Using Available Documents to Verify Information Reported on Business Tax Returns*, Reference No. 2002-30-185 (Sept. 2002).

[56] Internal Revenue Service, Dallas/New Orleans/Oklahoma City Research site, Report of Business Master File (BMF) Information Returns Program (IRP) Nonfilers for Tax Year 2000, Research Project 02.08.003.03 (July 2004). Review results indicated IRS would benefit by matching IRP information to the BMF nonfiler data prior to conducting delinquency checks and issuing notices,13.

Federal Payment Levy Program

Operation and Procedures

As explained above, Congress established the Federal Payment Levy Program (FPLP) to ease the administrative burdens of collecting taxes by levy.[57] Internal Revenue Code section 6331(h) authorizes the IRS to continuously levy up to 15 percent of certain payments, including contractor/vendor payments that were previously exempt from continuous levy.[58]

The IRS administers the FPLP jointly with the Department of the Treasury's Financial Management Service (FMS), which "provides central payment services to federal program agencies, operates the federal government's collections and deposit systems, provides government wide accounting and reporting services, and manages collection of delinquent debt."[59] To identify taxpayer accounts for the FPLP, the IRS electronically sends to the FMS a file of delinquent accounts, which are matched against FMS records to locate federal payment recipients with delinquent tax debts. When a match is found, FMS notifies the IRS, which sends the taxpayer a final notice with appeal rights (if one has not already been issued). If the delinquency is not resolved though an appeal, the IRS sends FMS a levy electronically. FMS can then reduce any payments subject to the levy by 15 percent until the delinquency is paid, other arrangements are made to satisfy the debt, or the IRS otherwise releases the levy.[60]

Table 1.16.2 shows the number and dollar amounts collected through the FPLP for the past three fiscal years.[61]

TABLE 1.16.2, FPLP LEVY STATISTICS

	FY 20014	FY 2002	FY 2003
Total number of levies on federal payments	778,158	1,435,386	1,011,448
Total number of fms matches on Federal contract payments	3,600	3,500	3,701
Collect from federal contract payments	$11.6 million	$10.2 million	$6.8 million

[57] IRC § 6331(h). Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97), Dec. 17, 1997.

[58] IRC § 6331(h)(2) Certain specified payments include any federal payments other than those for which eligibility is based on the income and/or assets of the recipients, and any annuity or pension payment under the Railroad Retirement Act or benefit under the Railroad Unemployment Insurance Act. Specified payments include unemployment benefits, worker's compensation, wages or salaries, and certain public assistance payments as described in IRC § 6334(a)(4,(7)(9)(11).

[59] Available at http://www.fms.treas.gov.

[60] IRM 5.19.9.3.1, Federal Payment Levy Program.

[61] Data provided by Wage and Investment, Filing and Payment Compliance on Sept. 8, 2004.

Problems with Federal Payment Levy System and Federal Contractors

In a February 2004 report, the GAO found the FPLP could become more effective in collecting delinquent taxes owed by DOD contractors. As pointed out above, the GAO noted that as of September 2002, over 27,000 DOD contractors owed $3 billion in unpaid taxes, and many of them continued to receive contract payments without paying taxes.[62]

The GAO attributed this problem to several factors. Two major factors were (1) DOD did not report all contractor information to the Treasury Offset Program for IRS matching; and (2) certain IRS policies and procedures delayed delinquency cases from entering the FPLP.[63]

The Treasury Offset Program (TOP) is an FMS debt collection program that matches the names and TINS of recipients of federal payments against names and TINS on the IRS delinquent accounts file.[64] If a federal payee has a delinquent account in the FPLP, the TOP system will match the delinquency to the payment and collect the 15 percent levy.[65] The GAO reported, however, that the DOD only reports payments to the TOP for one of its sixteen vendor payment systems. In 2002, DOD paid out $97 billion to contractors through systems not reported to the TOP.[66] Thus, these payments were not available for TOP matching and collection.

Another issue addressed by the GAO was IRS policies and procedures that restrict and delay FPLP cases.[67] According to the GAO, taxpayer accounts cannot enter the FPLP if they are also in the IRS Automated Collection System (ACS) or are waiting to be assigned to a revenue officer.[68] The GAO report explains that "IRS policy is to exclude accounts in the ACS . . . primarily because officials believed they lack the resources to issue levy notices and respond to the potential increase in telephone calls from taxpayers responding to the notices."[69] The report adds that the IRS excludes cases from the FPLP while they await assignment to a revenue officer to ensure that affected taxpayers receive proper notice of the potential levy.[70] Under these policies, it may take several years for a delinquent account to be assigned to a revenue officer.[71]

[62] GAO Report to Congressional Requesters, *DOD Pays Billions of Dollars to Contractors That Abuse the Federal Tax System*, GAO-04-95, 3 (Feb. 2004).

[63] *Id* at 3-4.

[64] *Id*. at. 2

[65] *Id*. at 10

[66] *Id*. at 3.

[67] *Id*. at 22.

[68] *Id*. at 22, 23.

[69] *Id*. at 23.

[70] *Id*. The GAO report notes, however, that IRS policy with respect to FPLP exclusion during the assignment phase was expected to change in early 2004.

[71] *Id*. As of September 30, 2002, the IRS listed $81 billion of cases in these four phases: 17 percent were in notice status, 17 percent were in ACS, 26 percent were in field collection, and 40 percent were in the queue awaiting assignment to the field. At the same time these four phases take place, sometimes over the course of years, DOD contractors with unpaid taxes continue to receive billions of dollars in contract payments.

The Senate Permanent Subcommittee on Investigations held a hearing in response to the GAO's findings. At this hearing, Commissioner Mark Everson testified that the IRS had recently changed procedures in order to allow the FPLP to capture more delinquent taxpayer accounts. Delinquent accounts residing in the IRS collection queue[72] are now to be included in the FPLP unless they meet criteria for exclusion, along with delinquent accounts assigned to revenue officers, which were previously excluded from the FPLP. Revenue officers will continue to assess each case individually subsequent to the 15 percent FPLP levy and may either remove the case from FPLP or manually attach 100 percent of the levy proceeds.[73] The IRS communicated these changes to employees by posting alerts on its internal Servicewide Electronic Research Program website and revising the relevant Internal Revenue Manual provisions. IRS employees were also alerted to the increased taxpayer contracts they will receive from additional FPLP cases.[74]

FPLP collections have increased since the change in policy. From January through June 2004, the IRS received 207 levy payments on DOD contractors totaling $2.4 million, compared to 43 levy payments and $323,000 for the same period in 2003.[75] These changes also made an additional 3.1 million Federal contractor tax debts totaling $28.9 billion available for levy during the first six months of 2004, compared to 680,061 tax debts totaling $5.1 billion available for the same period in 2003.[76]

Central Contractor Registration Database

In 1998, the Department of Defense established the Central Contractor Registration (CCR) as the primary repository for contractor information shared with other Federal agencies.[77] CCR is a web-based database that provides a common source of vendor data for government agencies. The Office of Management and Budget (OMB) instructed Federal agencies to use the CCR as the single validated source of information about vendors doing business with the Federal government. Federal Acquisition Regulations require nearly all Federal contractors to register in the CCR prior to the award of a contract or agreement.[78]

[72] The queue contains collection cases awaiting assignment to a revenue officer.

[73] DOD Contractors That Cheat on Their Taxes and What Should Be Done About It: Hearing Before the Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs, 108th Cong., 2nd Sess. (Feb. 12, 2004) (Statement of Mark W. Everson, Commissioner, Internal Revenue) 4.

[74] IRM 5.19.3.2.1, FPLP Selection Criteria

[75] Report to Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations, Federal Contractor Tax Compliance Task Force, 2.

[76] *Id.*

[77] GAO Report to Congressional Requesters, *Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-95, 7 (Feb. 2004).

[78] Federal Acquisition Regulation Subpart 4.11, implemented Oct. 1, 2003. Exceptions include purchases that use a government wide commercial purchase card as both the purchasing and payment mechanism; classified contracts which could compromise the safeguarding of classified information or national security; contracts awarded by deployed contracting officers in the course of military and emergency operations; contracts to support unusual or compelling needs; awards made to foreign vendors for work performed outside the United States, and micro-purchases that do not use the electronic funds transfer (EFT) method for payment and are not required to be reported. Federal Acquisition Regulation, Subpart 4.1102(a).

Contractors are also required to keep their information in the CCR current and annually confirm that the information is correct.[79]

The CCR includes various information, including a contractor's name and TIN.[80] In its February 2004 report, the GAO noted that the CCR contained nearly 4,900 business TINs that that did not match IRS Master Files.[81] If a contractor has an invalid TIN in the CCR, there will be no match in the FMS' TOP if the contractor also has an unpaid tax liability.[82] At the February 2004 hearing, Commissioner Everson testified that the IRS is working with DOD to ensure that the vendor TINS on the CCR are accurate to the extent permitted by IRC § 6103.[83]

Federal Contractor Compliance Task Force

As a result of the February GAO report and the subsequent hearing, the DOD, Defense Financial Accounting Service, IRS, FMS, GSA, OMB and Department of Justice formed the Federal Contractor Compliance Task Force (Task Force) to study ways to improve Federal contractor tax compliance. The Task Force issued a report to the Senate Permanent Subcommittee on Investigations and recommended four ways to improve the effectiveness of the FPLP:

1. Maximize the number of delinquent tax debts that the IRS makes available for matching.
2. Maximize the number of DOD payments available for matching.
3. Improve the timing of Collection Due Process notices that are required to be issued to taxpayers before a levy can be made.
4. Establish a process for validating Federal contractor TINs.[84]

[79] Federal Acquisition Regulation; Central Contractor Registration, 68 Fed. Reg. 56,669 (2003) (to be codified at 48 C.F.R. pts. 1, 2, 4, 13, 32, and 52).

[80] *Id.*

[81] General Accounting Office Report to Congressional Requesters, *Some DOD Contractors Abuse the Federal Tax System with little Consequences*, GAO-04-95, 17 (Feb. 2004).

[82] *Id.*

[83] DOD Contractors That Cheat on Their Taxes and What Should Be Done About It: Hearing Before the Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs, 108th Cong., 2nd Sess. (Feb. 12, 2004) (statement of Mark W. Everson, Commissioner, Internal Revenue). IRC § 6103 governs the confidentiality and disclosure of returns and return information.

[84] Report to Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations, Federal Contractor Tax Compliance Task Force, i.

IRS COMMENTS

In General

The IRS Wage and Investment Operating Division administers the Federal Payment Levy Program (FPLP) jointly with the Department of Treasury's Financial Management Services (FMS). The Office of Federal State and Local Government (FSLG) in the Tax Exempt and Government Entities Operating Division is responsible for federal tax administration issues relating to Federal agencies, state and local government units and their subordinate agencies.

We appreciate the TAS report's acknowledgment that the IRS has increased collections through the FPLP and that the IRS has numerous efforts underway to resolve remaining issues with contractor noncompliance.

The TAS report notes that, in the past, there was substantial noncompliance with the requirement to report Federal contracts in excess of $25,000 under section 6050M of the Internal Revenue Code. The IRS has addressed this issue. Effectively, there are two entities that file quarterly returns related to Federal contracts (Forms 8596). One of these is the United States Postal Service, which files on its own behalf. The other is the Federal Procurement Data Center (FPDC), which files on behalf of other Federal agencies. Past filing problems arose for two principal reasons. First, the USPS was unable to file with the IRS after January 1, 2000, because the USPS did not conform its file format to the IRS's post-Y2K format. This situation has been corrected and the USPS has resumed filing. Second, the FPDC's filings were interrupted in tax year 2002 due to outsourcing of certain of its data-gathering processes and other considerations. This situation also has been corrected and filing will resume in February, 2005.

The IRS will continue to pursue noncompliance in this area. For example, as part of its FY 2005 strategic initiatives, FSLG will examine Federal agency compliance with the information reporting requirements of sections 6050M and 6041A. Among other things, the examinations will enable FSLG to determine the extent of noncompliance by Federal agencies, and then respond with appropriate enforcement and educational strategies.

The TAS report's discussion regarding the filing requirements under section 6050M does not take into account the fact that reporting has changed from paper forms to electronic media. The report also misapprehends the filing requirements under section 6041A when it concludes that all Federal contracts reported under section 6050M must also satisfy filing requirements under section 6041A. As discussed below, these two separate filing requirements do not always overlap.

Improving tax compliance by Federal contractors is a goal that requires the combined efforts of the IRS and the responsible Federal agencies. Recognizing this, the IRS, joined by the Department of Defense (DOD), the Defense Finance and Accounting Service

(DFAS), the Financial Management Service (FMS), the General Services Administration (GSA), the Office of Management and Budget (OMB), and the Department of Justice (DOJ) established the Federal Contractor Tax Compliance Task Force (FCTC) in March 2004. The FCTC has identified improvements that would enhance the effectiveness of the FPLP, and these improvements are now being implemented.

Current Law

IRC § 6050M requires each Federal executive agency to file a return (Form 8596), on a quarterly basis, for all contracts entered into in excess of $25,000. Section 6050M requires reporting when the contract is entered into, not when payment is made. Further, section 1.6050M-1(d)(5) of the Treasury Regulations provides that a Federal executive agency may elect to have the Director of the Federal Procurement Data Center (FPDC) make the required returns to the IRS with respect to such contracts. Virtually all Federal agencies other than the United States Postal Service (USPS) have elected to file through the FPDC.

Section 6041A requires every person engaged in a trade or business to file an information return (Form 1099-MISC) with respect to payments made by such person during a calendar year with respect to its trade or business.

Section 6331(h) authorizes the IRS to continuously levy up to 15 percent of certain payments, including contractor/vendor payments.

Form 8596 – Information Return for Federal Contractors

The IRS has worked diligently over the past two years to improve compliance by Federal agencies and the USPS. We are pleased to note that the FPDC and the USPS are now positioned to file all required Forms 8596 electronically. Further, we believe that past filing problems have been corrected and should not recur.

With respect to this point, we wish to note that the IRS has met its filing requirements under Section 6050M for all tax years. The IRS's Office of Procurement Policy annually has filed the Service's procurement data with the FPDC, in accordance with section 1.6050M-1(d)(5). Suggestions in the report that the IRS has not met its filing obligations are inaccurate.

In September 1997, the FPDC began accepting only electronic/magnetic media filings from Federal agencies. This coincides with and explains the cessation of paper filings of Forms 8596 with the IRS. Further, beginning October 1, 2004, Federal procurement information is electronically input directly into the FPDC-New Generation (FPDC-NG) system at the time a Federal agency executes a contract, rather than quarterly, as was the case under the old system.

The TAS report describes the filing requirements contained in existing regulations but does not take into account changes in information technology that have occurred since Form 8596 was first developed. The regulations do speak of paper filing of Form 8596, but all Federal agencies and the FPDC have moved beyond paper to electronic filing. The lack of paper Forms 8596 is not a systemic problem, but rather reflects technological advances since 1986, when the regulations were adopted. In light of the current electronic filing regimes, FSLG has recommended that those sections of the regulations concerning paper filing be updated, and the IRS Office of Chief Counsel has accepted the project.

Form 1099-MISC

The TAS report's discussion of filing requirements under section 6041A (Form 1099-MISC) indicates a misunderstanding of the different requirements under sections 6050M and 6041A. Section 6050M requires reporting all contracts entered into by a Federal agency relating to goods and services. Section 6041A requires reporting payments made for services only. Reporting under section 6050M is triggered by the execution of a contract. Reporting under section 6041A is based on the timing of the payment for services made under the contract.

Due to these differing requirements, reports on Form 8596 filed on behalf of a Federal agency by the FDPC will not necessarily match the Forms 1099-MISC filed by the Federal agency itself. For example, suppose the FDPC files a Form 8596 on behalf of Federal agency A with regard to a contract with Corporation B under which Corporation B will provide paper goods to Federal agency A during calendar years 2002-2005. Under section 6041A, during each tax year, Federal agency A is required to file Forms 1099-MISC only for payments it makes for services received. Thus, no Form 1099-MISC would be filed for the payment made by Federal agency A to Corporation B for the paper goods received.

Matching of Taxpayer Identification Numbers (TINs)

The TAS report accurately notes that a major issue confronting the IRS is the continuing use of incorrect Taxpayer Identification Numbers (TINs) in the filing of Forms 1099 and Forms 8596 by Federal agencies. On October 26, 2004, the FCTC Task Force reported to Congress that the IRS is developing a consent based TIN verification system in conjunction with the Contractor Central Registration (CCR)[85] program. When section 6103 taxpayer information disclosure issues are resolved, the planned system will substantially reduce the use of erroneous TINs by Federal agencies. Among other things, the planned system will:

[85] The CCR is a Department of Defense database of vendors that have registered to do business with the Federal government. This system is maintained by the Department of Defense.

- Require taxpayers to consent to TIN/Name verification as a condition of competing for Federal contracts;
- Make use of the CCR as the repository for correct TINs to be used by Federal agencies.

Federal Payment Levy Program

The TAS report further notes that the IRS has implemented a number of changes intended to increase the number of tax debts available for levy in the FPLP. These changes are already producing results. The levies on which Federal contractor payments were received through the FPLP increased 103 percent from 10,228 in FY 2003 to 20,720 in FY 2004. The total number of levies overall on which payments were received through the FPLP increased by 8 percent to 667,885.[86] Financial Management Service (FMS) matches on Federal contract payments increased by 208 percent, from 3,701 to 11,401.[87] Additionally, from FY 2003 to FY 2004, the amount collected from Federal contractor payments rose by 160 percent, from $6.1 million to $15.9 million, while overall collections in the FPLP increased by 28 percent to $113.7 million.

The FCTC Task Force continues to oversee implementation of recommendations to improve the effectiveness of the FPLP as outlined in its October 26, 2004 report to the Senate Permanent Subcommittee on Investigations. Members of the FCTC Task Force also are working with the Department of Defense (DOD) to ensure that vendor TINs on the CCR are accurate to the extent permitted by section 6103. As additional recommendations are implemented through FY 2006, the IRS anticipates continued improvements in the collection of delinquent tax debts through the FPLP.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate commends the IRS for its stated efforts to assist the FPDC and the USPS in filing Forms 8596 electronically (resuming in February 2005 for FPDC filings). As of December 31, 2004, however, the IRS had no record of any Forms 8596 filed by the FPDC since the 2001 tax year.[88] *This affected all Federal Agencies who elected to have the FPDC file the required forms on their behalf.*[89] *The National Taxpayer Advocate notes, however, that there should have been a better system in place to identify and correct the electronic transmission problems that appear to have been the cause of the missing Forms 8596.*

[86] The FPLP Levy Statistics chart cited in the Report represents the total number of tax account modules on which levies were issued on Federal payments in the FPLP, not the "Total Number of Levies on Federal Payments."

[87] Each time the FPLP receives a first-time match from FMS, if a Final (Collection Due Process) Notice has not been issued, the FPLP will issue the Final Notice. This count is based on how many notices were issued on non-duplicative matches. The same explanation applies to the "Total Number of FMS Matches on Federal Contract Payments" cited on the FPLP Levy Statistics chart in the report.

[88] Email from IRS MITS Specialist (Policy & Planning), received on Aug. 11, 2004. See TAS report *supra*.

[89] Including the IRS. Email from IRS Office of the Chief Financial Officer, Accounts Payable Section, Beckley Finance Center, received on Sept. 1, 2004.

The National Taxpayer Advocate believes that once these electronic filing problems are corrected, the IRS will again be receiving the information it needs to satisfy its Congressional mandate to prevent Federal contractors from reaping the benefits of Federal contracts without fulfilling their tax obligations. While the National Taxpayer Advocate commends the IRS' efforts to ensure that Forms 8596 are filed once again, she is concerned that the IRS response seems to place more emphasis on efforts to receive the forms themselves rather than on improved efforts to use the information contained on the forms to more closely monitor Federal contractor compliance.

The IRS response goes to great lengths to point out that the reporting requirements of IRC §§ 6050M and 6041A are distinct and serve different purposes. But the IRS response says nothing about how the information obtained by these requirements could be used to monitor and enhance Federal contractor compliance.

The TAS report also explains the differences between these two reporting requirements (see TAS report supra) and recommends that the information obtained be associated to the extent possible to determine both information and tax return filing compliance, and to identify future income sources for any necessary levies. Using the information in this manner also seems consistent with Congressional intent, as explained in the TAS report. The National Taxpayer Advocate recommends that the IRS continue its efforts to receive the information required by IRC §§ 6050M and 6041A, and begin exploring ways that it could use this information to enhance Federal contractor compliance.

The National Taxpayer Advocate agrees with the IRS recommendation to eliminate the paper filing option for Form 8596. The IRS should also update the applicable IRM sections, Revenue Procedures, forms and instructions to be consistent with this change.

We commend the efforts of the Federal Contractor Compliance Task Force to enhance the effectiveness of the FPLP and to work with the DOD to ensure CCR TIN accuracy. The National Taxpayer Advocate notes, however, that the IRS initiative to develop a "consent" based TIN verification system is not consensual if it is required. A consent cannot be mandatory.

In short, the National Taxpayer Advocate supports IRS efforts to address the problem of Federal contractor noncompliance. TAS will continue to work with the IRS to ensure that taxpayer rights are protected while the IRS remedies the Federal contractor noncompliance issues that Congress first brought to light in 1992.

MOST SERIOUS PROBLEM: INDEPENDENCE OF THE OFFICE OF APPEALS

RESPONSIBLE OFFICIAL

David B. Robison, Chief of Appeals

DEFINITION OF PROBLEM

The mission of the IRS Appeals division (Appeals) is to "resolve tax controversies, without litigation, on a basis which is fair and impartial to both the government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service."[1] To achieve this mission, Appeals must possess true independence from the IRS compliance functions and enforcement divisions, and afford all taxpayers reasonable access to the Appeals process. If taxpayers perceive that Appeals does not provide a fair and independent forum for resolving tax controversies, or if they do not believe they can reasonably access Appeals, they will bypass Appeals and proceed directly to litigation. Worse, they may give up on the system and feel cheated, becoming more receptive to not fully complying with the tax laws. Since few taxpayers have the resources, time or gumption to undertake litigation, they may become disaffected and more prone to cheat on taxes. Thus, without independence and reasonable access, Appeals cannot accomplish its mission and the costs of tax controversy resolution increase for both taxpayers and the government.

In recent years, Appeals has experienced an increase in case receipts that has led to cycle time delays. When these delays are unreasonably lengthy, they can limit taxpayer access to Appeals. Appeals recognizes that it has inventory and cycle time problems.[2] Unfortunately, however, some of its remedies for these problems are compromising its independence. If taxpayers perceive that Appeals is not truly independent of the IRS, they will not use Appeals.

ANALYSIS OF PROBLEM

Background: History

The federal government has provided an administrative appeal to taxpayers who do not agree with proposed tax assessments since the Treasury Department was established by the Act of 1789.[3] Since its inception, Treasury has maintained a general policy preference for settling tax disputes administratively rather than by litigation.[4] In accordance with this policy, the IRS Office of Appeals was established in 1927 as the "Special Advisory Committee" (SAC).[5] The SAC was formed in an attempt to deal administratively with

[1] IRM 8.1.1(2) (Feb. 1, 2003).

[2] *See* Appeals Strategy and Program Plan, *FY 2005/2006*.

[3] Act of Congress Establishing the Department of the Treasury, September 2, 1789, Chapter XII, Section 5.

[4] IRS Document 7225, "History of Appeals" (Nov. 1987).

[5] *Id.*

the backlog of cases pending before the Board of Tax Appeals – the predecessor of the United States Tax Court.[6] Since the beginning, Appeals' primary responsibility has been to "facilitate and expedite the settlement of tax disputes without formal trial."[7]

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)[8] recognized Appeals' historical responsibility and mandated that it continue. RRA 1998 requires the IRS to "ensure an independent appeals function within the [IRS], including the prohibition . . . of *ex parte* communications between appeals officers and other [IRS] employees to the extent that such communications appear to compromise the independence of the appeals officers."[9]

INDEPENDENCE

RRA 98 mandates that Appeals be independent from IRS enforcement and compliance functions. Even before RRA 1998, Treasury Regulations required Appeals officers to exercise "strict impartiality between the taxpayer and Government."[10] Appeals has long recognized that independence is essential to its mission of resolving tax controversies without litigation. On its 60th anniversary, Appeals explained the necessity of independence in both fact and appearance:

> To be effective, the administrative appeals function must not only be fair but must *appear to be fair* and free of conflict of interest. This is done by separating personnel involved in the final administrative appeals process from personnel responsible for the original examination or assessment. Experience has taught the Internal Revenue Service the wisdom of placing the appeals machinery outside the control of the functions which initiated the proposed liability. Otherwise, it is not possible to assure taxpayers that their cases will receive impartial consideration. This . . . recognizes that taxpayers believe impartiality can be assured only if a dispute is considered by someone outside the area which originally raised the issue.[11]

The actuality and perception of an independent Appeals function are particularly important as the IRS continues to emphasize enforcement measures.[12] Even if Appeals maintains independence in fact, taxpayers will bypass the Appeals process if Appeals does not also convey the appearance of fairness to taxpayers and independence from IRS enforcement.

[6] *Id.* There were over 18,000 cases pending before the Board of Tax Appeals when the SAC was created.

[7] IRS Document 7225, "History of Appeals," 7 (Nov. 1987).

[8] Pub. L. No. 105-206.

[9] Pub L. No. 105-206 § 1001(a)(4).

[10] Treas. Reg. § 601.106(f)(1).

[11] IRS Document 7225, "History of Appeals," 7-8 (Nov. 1987) (emphasis added).

[12] *See* IRS Strategic Plan for 2005-2009.

SPECIFIC ACCESS AND INDEPENDENCE CONCERNS

Taxpayers have concerns about their ability to access Appeals, and Appeals' independence and fairness. A January 2004 IRS customer satisfaction survey found that Appeals customers are most dissatisfied with independence and access issues. Independence issues include both Appeals independence and fairness. Access issues include the length of the Appeals process, the time it takes to hear from Appeals, and the adequacy of resources applied by Appeals. The survey findings revealed that although 63 percent of surveyed Appeals customers were satisfied with their overall experience with Appeals:

- 39 percent were less than satisfied with the independence of Appeals;
- 41 percent were less than satisfied with Appeals' fairness in resolving their cases;
- 52 percent were less than satisfied with the length of the Appeals process;
- 57 percent were less than satisfied with the time it took to hear from Appeals after they first notified the IRS that they wanted an Appeals conference; and
- 43 percent were less than satisfied with the adequacy of resources applied by Appeals.[13]

These findings are significant because they present taxpayers' perceptions about Appeals. Taxpayer perception is a critical measure for Appeals because the Appeals process is voluntary. In other words, if taxpayers believe they cannot reasonably access the Appeals process, or believe that Appeals will not give their case a fair and independent review, they will bypass Appeals and proceed to litigation or noncompliance.[14]

ACCESS CONCERNS

Appeals Inventory Delays

Taxpayers do not have adequate access to Appeals when the process is unreasonably lengthy. Appeals inventory and case processing delays have caused taxpayers significant concerns about the timeliness of resolving their cases through Appeals.[15] The National Taxpayer Advocate previously raised this issue in her 2003 Annual Report to Congress.[16] Table 1.17.1 shows Appeals' total case receipts, closures and ending inventory numbers for both docketed and non-docketed cases from fiscal years 1997 through 2004.[17]

[13] IRS Customer Satisfaction Survey, Appeals National Report results covering October 2003 through March 2004, Pacific Consulting Group, Report Summary, 6 (Sept. 2004).

[14] *See* IRS Document 7225, "History of Appeals," 7-8 (Nov. 1987).

[15] IRS Customer Satisfaction Survey, Appeals National Report results covering October 2003 through March 2004, Pacific Consulting Group, Report Summary, 6 (Sept. 2004).

[16] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. Dec. 2003), 182-196.

[17] Extracted from Appeals Centralized Database Systems, Unistar Reports, Table 17, and selected statistics compiled by the Office of Appeals Tax Policy and Procedure. Note that a docketed case involves a taxpayer who has petitioned the United States Tax Court and is scheduled to the court's docket. A non-docketed case is one that typically involves an administrative protest by the taxpayer of the findings and conclusions of the Examination, Collection, or other IRS function that initially considers a taxpayer's case.

TABLE 1.17.1 APPEALS HISTORICAL DATA FY 1997 TO FY 2004[18]

	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02	FY 03	FY 04
Receipts	76,684	65,434	58,679	55,431	68,198	76,397	98,378	98,677
Non-Docketed	54,753	48,482	43,513	44,454	57,700	66,106	83,918	81,657
Docketed	21,931	16,952	15,166	10,977	10,498	10,291	14,460	17,020
Closures	75,331	71,918	61,507	55,088	54,748	68,015	84,677	103,946
Non-Docketed	50,998	49,120	41,878	39,181	43,394	56,077	70,167	86,123
Docketed	24,333	22,798	19,629	15,907	11,354	11,938	14,150	17,823
Ending Inventory Totals	59,329	51,143	47,461	46,519	58,968	66,174	79,213	73,308
Non-Docketed	33,321	29,350	28,524	30,405	43,348	50,185	61,094	53,444
Docketed-Appeals Judicated	16,625	13,216	11,196	7,662	8,934	9,075	10,901	11,343
Docketed-Counsel Judicated	9,383	8,577	7,741	8,452	6,686	6,914	7,218	8,521

Table 1.17.1 shows that from FY 2000 to FY 2004, Appeals case receipts have increased by 78 percent.[19] Receipts are also expected to rise by an additional 16 percent in FY 2005 and another 12 percent in FY 2006.[20] Much of this growth is attributable to the change in Appeals' customer base resulting from RRA 98, which gave Appeals jurisdiction over Collection Due Process (CDP) hearings, Offer in Compromise (OIC), Earned Income Tax Credit (EITC) and joint and several liability (innocent spouse) cases.

TABLE 1.17.2, CLOSED CASE CYCLE TIME (IN DAYS) FY 2002, FY 2003 AND FY 2004

Cycle Days	FY 02	FY 03	FY 04
CDP (Collection Due Process)	274	253	241
OIC (Offer in Compromise)	331	313	253
INNSP (Innocent Spouse)	384	446	450
POST PEN (Post Penalty)	166	194	166
Exam/TEGE	391	372	333

Tables 1.7.1 and 1.17.2 indicate that Appeals case cycle time generally improved during FY 2004.[22] A cycle time of 261 days for non-docketed cases, however, demonstrates that

[18] Historical Data Report 1994 through 2004, compiled by the Office of Appeals, Director of Tax Policy & Procedures (Nov. 26, 2003 and Oct. 26, 2004).

[19] Appeals Strategy and Program Plan FY 2005/2006.

[20] *Id.*

[21] Appeals Inventory Reports, FY 2002, FY 2003 and FY 2004, compiled by the Office of Appeals, Director of Tax Policy & Procedures.

[22] With the notable exception of innocent spouse cases, which have increased from 384 days in FY 2002 to 450 days in FY 2004 Appeals Inventory Reports, FY 2002, FY 2003 and FY 2004, compiled by the Office of Appeals, Director of Tax Policy & Procedures.

much work remains to ensure that taxpayers have reasonable access to the Appeals process.[23]

THE RIGHT TO AN APPEAL

In addition to the problems caused by cycle time and inventory delays, the IRS has also made overt efforts to limit certain taxpayers' access to the Appeals process. Appeals procedure regulations describe a taxpayer's access to Appeals as a "right."[24] In 1988, Congress directed the IRS to prepare a simple, non-technical statement setting forth taxpayer rights, including "the procedures by which a taxpayer may appeal any adverse decision of the Service (including administrative and judicial appeals)."[25] The IRS responded with Publication 1, *Your Rights as a Taxpayer*.[26] Section VII of Publication 1's "Declaration of Taxpayer Rights" says, "If you disagree with [the IRS] about the amount of your tax liability or certain collection actions, you have the right to ask the Appeals Office to review your case. You may also ask a court to review your case."[27] IRS Publication 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree*,[28] and Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*[29] also address appeal rights. Publication 556 explains that a taxpayer's appeal "must come within the scope of the tax laws," and cannot be based only on "moral, religious, political, constitutional, conscientious, or similar grounds."[30]

Oral Appeal Rights

The Treasury Regulations setting forth the procedural rules for Appeals provide that a taxpayer can orally request Appeals consideration of an assessment (1) in all office interview or correspondence examination cases; or (2) in field examination cases if the total proposed additional tax including penalties, proposed overassessment, claimed refund, or Offer in Compromise is $2,500 or less for any taxable period.[31] In 1993, the IRS proposed new Appeals procedure regulations that eliminated taxpayers' oral Appeal rights.[32] Although these regulations are not in final form, the IRS appears to be following them with respect to oral appeal rights because there are no references to the possibility of an oral appeal in any of the IRS publications setting forth a taxpayer's appeal rights.[33] In

[23] Historical Data Report 1994 through 2004, compiled by the Office of Appeals, Director of Tax Policy & Procedures (Nov. 26, 2003 and Oct. 26, 2004).

[24] Treas. Reg. § 601.106(b).

[25] Pub. L. No. 100-647, Title VI, § 6227(a) (Nov. 10, 1988).

[26] IRS, *Your Rights As A Taxpayer*, Publication 1 (Rev. 08-2000).

[27] *Id*.

[28] IRS, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree*, Publication 5 (Rev. 01-1999).

[29] IRS, *Examination of Returns, Appeal Rights, and Claims for Refund*, Publication 556 (Rev. 06-2004).

[30] *Id*. *See also* Treas. Reg. § 601.106(b).

[31] Treas. Reg. § 601.106(a)(1)(iii)(a).

[32] Treas. Reg. § 601.106, (Proposed Sept. 20, 1993)

[33] *See* IRS Publications 1, 5 and 556.

fact, these publications specifically note that an appeal must be in writing. The National Taxpayer Advocate also understands that the IRS is considering permanently eliminating oral Appeal rights.

The National Taxpayer Advocate has concerns about the effects of eliminating oral Appeal rights in *de minimus* cases. These small cases typically involve low to moderate income taxpayers who do not have representation. Eliminating oral Appeal rights for these taxpayers may saddle them with an unreasonable burden. The National Taxpayer Advocate suggests that rather than eliminate oral Appeal rights, the IRS could electronically document oral Appeal requests and prepare computer generated acknowledgement letters to send to taxpayers. These procedures would place minimal administrative burdens on the IRS and relieve taxpayers of the burden of preparing a written protest in very small cases.

INDEPENDENCE CONCERNS

Appeals recognizes that it has access problems attributable to increased inventory and processing delays. Some of Appeals' efforts to alleviate inventory and processing problems, however, appear to favor processing speed and inventory management over independence. Other initiatives call into question the independence of all Appeals' decision making. Evidence of these compromises is found in Appeals' new Campus Settlement Initiative, the current state of the rule prohibiting Appeals *ex parte* communications, and Appeals participation in recent IRS enforcement activities directed at abusive tax shelters.

Campus Specialization Initiative

In an attempt to answer taxpayers' concerns about inventory and case processing time and to better allocate resources, Appeals recently implemented the Campus Specialization Initiative (CSI), moving certain cases from the field to be worked in IRS campuses. Appeals believes the CSI will improve cycle times and increase cost effectiveness and efficiency by working cases at the source of most of Appeals' inventory.[34]

Under the CSI, each campus will specialize in a particular type of case. Appeals believes that this will standardize its processing procedures and enable the field offices to concentrate on more complex cases.[35]

In FY 2004, Appeals initiated campus operations in the IRS Brookhaven, Fresno, and Covington campuses and expanded operations in the Ogden and Philadelphia campuses.

[34] Appeals Friday Report, April 9, 2004. Sixty-five percent of Appeals' workload comes from compliance functions at the campuses. Compliance functions are those that originate at the campus, such as penalty appeals, automated underrreporter, computer notice and matching programs. Information supplied by Director of Appeals Tax Policy and Procedure, W&I and SB/SE.

[35] Appeals Friday Report, *New Campus Team = Employee Satisfaction*, April 9, 2004.

- Appeals is fully operational at the Brookhaven campus, handling penalty appeals (PENAP) cases, and two-thirds of Appeals Centralized Offer in Compromise (COIC) inventory.
- In the Fresno campus, Appeals is working docketed "S" cases[36] from its own compliance function and, in October 2004 will receive additional compliance work from the Austin, Texas campus. In the first quarter of fiscal year 2005, Fresno will begin working CDP cases from the Fresno Automated Collection Services (ACS) site and from the Kansas City campus.
- Appeals designated the Covington campus to work Joint and Several Liability (innocent spouse) cases. Covington is projected to handle about 50 percent of these cases.[37]
- In the Ogden campus, Appeals is working both docketed and non-docketed exam cases and PENAP cases.
- Appeals is also working docketed and non-docketed exam cases in the Philadelphia campus.

During FY 2005, Appeals expects to establish campus operations in Memphis with approximately 100 employees.[38] Appeals will work OIC, CDP and docketed and non-docketed exam cases in Memphis.

Appeals' FY 2005/2006 Strategy and Program Plan explains that the CSI is part of Appeals' strategy of "Getting the Right Work to the Right Employee" – or "matching case work to the skills and grade level of the individual employee."[39] Under this strategy, Appeals plans to shift its focus from its traditional "face-to-face" approach to a more flexible model. Appeals explains that certain case work is "highly portable" and that taxpayers would rather have a quicker resolution of their case than face-to-face contact with Appeals.[40]

Part of Appeals' Right Work/Right Employee strategy is also using IRS early retirement programs[41] "to optimize our resource alignment in support of our strategic objectives." If the Office of Personnel Management approves Appeals' early retirement program request, Appeals will use these programs to "target offices with staffing and workload imbalances."[42]

---

[36] "S" cases are docketed Tax Court cases that stem from compliance issues totaling less than $50,000, under IRC § 7463.

[37] Appeals Friday Report, *Status Report on Campus Operations*, May 21, 2004. Fifty percent (50%) of the Innocent Spouse cases are handled at Compliance level in Covington.

[38] *Appeals Strategy and Program Plan, FY 2005/2006.*

[39] *Id.*

[40] The *Strategy and Program Plan, FY 2005/2006* does not provide a source for these assertions.

[41] Early retirement programs include both Voluntary Early Retirement Authority (VERA) and Voluntary Separation Incentive Payment (VSIP) Authority.

[42] Appeals Strategy and Program Plan, FY 2005/2006.

Taken together, the Right Work/Right Employee strategy and the CSI strategy indicate that Appeals plans to increase efficiency by replacing a number of seasoned Appeals personnel who have worked in the traditional face-to-face model with campus employees who will work in the new "flexible model."

Appeals does indicate that it will develop a "competency-based Strategic Training Plan" that will "align with the long-term vision of the Appeals organization and position [Appeals] to provide the skills and knowledge . . . employees will require to effectively perform their duties."[43] Appeals also plans to develop measures to evaluate its strategies to more effectively utilize its existing staff to meet expected workload demands. Appeals is also exploring the possibility of implementing an Appeals-wide mentoring program.[44]

Although the CSI may help to decrease Appeals case cycle time and reduce inventories, the National Taxpayer Advocate has several concerns about this initiative. The first concern is limiting taxpayers' access to face-to-face contact with Appeals. The opportunity for face-to-face interaction with an Appeals officer is a significant feature of locating Appeals offices throughout the country. For example, one of the reasons that EITC exam cases often end up in Appeals is the taxpayer's need for face-to-face interaction and the personal attention that was not received during the exam process. It is not clear whether taxpayers will have any face-to-face contact with Appeals if their cases are assigned to a campus. Even if such contact is available upon request, transferring cases to local offices that provide it may cause backlogs at the local offices and further increase processing time. Further, taxpayer representatives will probably ask for face-to-face meetings in most cases, while unrepresented taxpayers will not know that face-to-face meetings are available. This places unrepresented taxpayers at an unfair disadvantage.

This lack of face-to-face contact is of particular concern for docketed "S" cases.[45] It seems doubtful that the campus environment will provide adequate personal attention for *pro se* or low income taxpayers in these cases. Many of these taxpayers are unclear about the difference between the Office of Chief Counsel and the IRS. Adding the IRS campus to the equation will only cause more confusion. The National Taxpayer Advocate is also concerned that handling docketed S cases in campuses may cause mailing delays in the time-sensitive trial calendar context. We wonder how the campuses will coordinate these cases with local IRS district counsel offices and if anyone from Appeals will be present to help settle these cases when they reach the Tax Court's calendar. It also seems reasonable to assume that docketed cases handled exclusively by telephone or correspondence in the campus environment will result in less case resolution, more poorly developed cases, and more litigation.

[43] Appeals Strategy and Program Plan, FY 2005/2006.

[44] *Id.*

[45] In FY 2003, 93 percent of all petitioned S cases were handled *pro se*. In FY 2004, 92 percent of all petitioned S cases were handled *pro se*.

Another concern with the CSI is the ability of campus Appeals employees to exercise independent judgment in the campus environment. The IRS campus culture has traditionally been production oriented with limited employee discretion and decision-making. Campus procedures do not lend themselves to the facts and circumstances analysis that is necessary in an Appeals case. These traditional restraints on judgment could hinder the effectiveness of Appeals in the campuses. Several Low Income Taxpayer Clinics (LITCs) have already expressed dissatisfaction with Appeals campus employees in joint and several liability and Offer in Compromise cases, commenting that the campus centralized reviewers apply a mechanical analysis.

A major concern with the CSI is the risk that Appeals will be seen as creating a "second class" of Appeals. The National Taxpayer Advocate understands that no Appeals employees at the campuses will be above the GS-12 level. In accordance with Appeals' strategy of "getting the right work to the right employee," taxpayers whose cases are assigned to a campus may feel as though they were not worthy of a "good" Appeals officer. Moreover, because there are no Grade 13 or 14 Appeals officers at the campuses, Appeals employees may perceive a campus as a second-class assignment. Additionally, the National Taxpayer Advocate questions Appeals assumption that OIC, EITC and CDP cases are "simple" and can be routinely handled by lower graded employees. In fact, the Taxpayer Advocate Service (TAS) itself has recognized that these cases can be complex and is revamping its case assignment methodology accordingly.

The National Taxpayer Advocate believes that for Appeals' CSI to be effective, Appeals must ensure that the traditional Appeals values of independence, fairness, and discretion are made part of its campus operations. This poses a challenge in the typical IRS campus environment. Some steps that may help Appeals successfully integrate traditional Appeals values into the campuses include employee training in exercising fairness and independent judgment, and working will various "levels" of taxpayers. Appeals should also train employees to communicate effectively using non face-to-face methods, such as telephone and written correspondence. Appeals should also meet with LITC programs and the Taxpayer Advocacy Panel to discuss the effects of the CSI on taxpayers and identify areas for improvement. Appeals appears to be taking steps in the right direction with its stated plans to develop measures to evaluate the effectiveness of its CSI and Right Work/Right Employee strategies, and to implement a mentoring program. The National Taxpayer Advocate believes it is imperative that Appeals follow through with these plans.

EX PARTE COMMUNICATION

A key component of Appeals independence is the prohibition against *ex parte* communications. *Ex parte* communications are "communications that take place between Appeals and another [IRS] function without the participation of the taxpayer or the taxpayer's representative."[46] RRA 1998 prohibits "ex parte communications between Appeals Officers and other [IRS] employees to the extent that such communications appear to compromise the independence of the Appeals Officers."[47] Rev. Proc. 2000-43 contains the official IRS guidance concerning the ex parte communications prohibition, stating that the prohibition is not absolute:

> The procedures set forth in this Revenue Procedure are designed to accommodate the overall interests of tax administration, while preserving operational features that are vital to Appeals' case resolution processes within the structure of the IRS and ensuring more open lines of communication between Appeals and the taxpayer/representative. Thus, in order to preserve the informal give-and-take and flexibilities that have been conducive to achieving settlements in Appeals, the guidance provided in this Revenue Procedure does not adopt the formal *ex parte* procedures that would apply in a judicial proceeding. The guidance is designed to ensure the independence of the Appeals organization, while preserving the role of Appeals as a flexible administrative settlement authority, operating within the [IRS'] overall framework of tax administration responsibilities.

Rev. Proc. 2000-43 thus appears to set forth a framework of independence vs. flexibility for Appeals *ex parte* communications with several exceptions to the prohibition:

- Appeals can obtain legal advice from the IRS Office of Chief Counsel as long as it is not provided by the same field attorneys who have previously given advice on the same issue to the IRS officials who made the determination Appeals is reviewing.
- The *ex parte* prohibition does not apply to certain cross-functional meetings, such as Appeals, Counsel, Collection and Examination (ACCE) meetings, industry wide ISP coordination meetings, Compliance Council meetings, or Large Case Policy Board meetings, as long as specific taxpayers are not identified.
- The IRS Commissioner and others responsible for overall IRS operations may communicate *ex parte* with Appeals to fulfill their responsibilities. These communications can be about specific cases and issues.

[46] Rev. Proc. 2000-43, 2000-2 C.B. 404.

[47] Pub. L. No. 105-206, § 1001(a)(4).

- Appeals can communicate *ex parte* concerning questions that involve "ministerial, administrative, or procedural matters and do not address the substance of the issues or positions taken in the case."
- The *ex parte* communications prohibition does not apply to issues that IRS Examination case managers can settle under Delegation Order 247.[48] Examination case managers have authority to settle Industry Specialization Program (ISP) coordinated issues that have Appeals Settlement Guidelines if the settlements are reviewed and approved by both the Examination and Appeals ISP Coordinators.
- The taxpayer or taxpayer's representative may waive the prohibition on *ex parte* communications. Taxpayers were required to waive the ex parte provision in order to participate in one of the IRS' first three tax shelter settlement initiatives.[49]
- The *ex parte* prohibition does not apply in Appeals' Fast Track Mediation or Fast Track Settlement programs.[50]

Many of these exceptions have weakened the Congressional prohibition on *ex parte* communications. The independence vs. flexibility approach to *ex parte* communications adopted by Rev. Proc. 2000-43 has resulted in an integrated, rather than independent, Appeals function. This integration is most evident in the tax shelter initiatives and the two Fast Track programs. Appeals participated with IRS enforcement functions in developing three of the four tax shelter settlement initiatives.[51] The IRS expects to offer additional tax shelter initiatives with Appeals fully integrated in their development and implementation.[52]

Practitioners have expressed concern that the *ex parte* exceptions that have allowed Appeals to be integrated in the settlement initiative process, and that allow Appeals to communicate with Compliance and Counsel in a taxpayer's absence in the Fast Track programs, have created the perception that Appeals is not independent from IRS enforcement.[53]

[48] 1996-1 C.B. 356.

[49] *See* Announcement 2002-96, 2002-2 C.B. 756, (concerning Corporate Owned Life Insurance (COLI)); Announcement 2002-97, 2002-2 C.B. 757 (concerning section 302/318 basis shifting); and Rev. Proc. 2002-67, 2002-43 I.R.B. 733, (concerning contingent liabilities). In the IRS' most recent tax shelter settlement initiative, dealing with "Son of BOSS" transactions, taxpayers were required to forfeit Appeals rights. *See* discussion *infra*.

[50] Rev. Proc. 2003-40, 2003-1 C.B. 1044 and Rev. Proc. 2003-41, 2003-1 C.B. 1047.

[51] Announcement 2002-96, 2002-2 C.B. 756; Rev. Proc. 2002-67, 2002-43 I.R.B. 733; Announcement 2002-97, 2002-43 I.R.B. 757.

[52] Sheryl Stratton, *IRS Appeals, Audit Initiative Announcements Abound at Conference*, 2004 TNT 192-4, October 1, 2004.

[53] *See* Vincent S. Canciello,*Tax Shelter Resolution Initiatives and the Independence of Appeals*, Vol. 5, No. 2, *Journal of Tax Practice and Procedure*, May 2003; Lee A. Sheppard, *Basis-Shifting Settlements not Playing Well*, 2002 TNT 232-7, December 3, 2002; and Sheryl Stratton, *IRS Appeals on the Move, Playing Offense and Defense*, 2003 TNT 115-2, June 16, 2003. When providing comments to the draft ex parte revenue procedure, the Tax Executives Institute said, "In developing guidance on the prohibition against ex parte communications, the question should not be, "Is this a communication legally permissible under the statue?" but rather, "Could this communication create an impression that Appeals' mission to provide a fair, impartial hearing has been compromised?" In other words, the guidance should err on the side of open communications between the IRS and the taxpayer." Comments on Notice 99-50, Ex Parte Communications, *The Tax Executive*, Dec. 15, 1999.

One practitioner (a former Chief of Appeals) argued that the *ex parte* waiver in settlement initiatives compromises Appeals independence by allowing Appeals to "discuss the strengths and weaknesses of a taxpayer's position with compliance and counsel in the absence of the taxpayer."[54] Similarly, the absence of the *ex parte* prohibition in the Fast Track programs compromises Appeals independence by allowing Appeals to discuss the merits of the issues with compliance and counsel before the negotiation session.[55] Allowing *ex parte* communications in Fast Track also permits the IRS to "compliance proof" Appeals' settlement offers by allowing Compliance to "preclude or influence a future Appeals settlement in which Compliance couldn't concur should a taxpayer subsequently go the traditional Appeals route."[56]

The National Taxpayer Advocate shares the concerns of these practitioners. The purpose of the *ex parte* communications rule is to "ensure an independent Appeals function."[57] If the exceptions to this rule create the perception among taxpayers and practitioners that Appeals is part of, rather than independent of, the IRS, taxpayers will bypass Appeals, and its mission of "resolving tax controversies without litigation" will be frustrated.[58] This frustration is particularly acute in an environment of increased enforcement.

The National Taxpayer Advocate is also concerned with the *ex parte* exceptions that allow Appeals to participate in enforcement oriented partnerships with IRS operating divisions. For example, Appeals is a member of the Servicewide Abusive Transaction Executive Steering Committee, where "executives from Counsel, Appeals, Criminal Investigation and the [IRS] operating divisions provide oversight for the IRS response to abusive tax transactions, schemes and devices."[59] In contrast, the National Taxpayer Advocate is not a member of this committee in order to preserve her independence and the independence of TAS.

Tax Shelter Settlement Initiatives

Appeals has participated in three of the four IRS settlement initiatives for abusive tax shelters. The IRS also expects to offer more tax shelter settlement initiatives with Appeals fully integrated in the development and implementation process. The Chief of Appeals publicly warned taxpayers electing not to participate in these settlement initiatives that they would not receive a better deal if they instead chose to take their case to Appeals:

[54] Vincent S. Canciello, *Tax Shelter Resolution Initiatives and the Independence of Appeals*, Vol. 5, No. 2, *Journal of Tax Practice and Procedure,* May 2003.

[55] *Id.*

[56] *Id.*

[57] IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 1001(a), (112 Stat. 685) (1998)

[58] *See* Vincent S. Canciello, *Tax Shelter Resolution Initiatives and the Independence of Appeals*, Vol. 5, No. 2, *Journal of Tax Practice and Procedure*, May 2003; Lee A. Sheppard, *Basis-Shifting Settlements not Playing Well*, 2002 TNT 232-7, December 3, 2002; and Sheryl Stratton, *IRS Appeals on the Move, Playing Offense and Defense*, 2003 TNT 115-2, June 16, 2003. *See* also Kenneth A. Gary, *Appeals Division Strong, IRS Official Says*, 2004 TNT 113-3, June 11, 2004 (quoting practitioners as "reluctant" and "unwilling" to "expose . . . clients to the appeals process").

[59] Process Guide for Combating Abusive Transactions, 3.

> For each of the settlement initiatives, Appeals has set parameters based on an assessment of the hazards of litigation. Taxpayers who do not avail themselves of these settlement initiatives should not expect a later administrative resolution of their case that is more advantageous.[60]

The fourth IRS settlement initiative addressed so-called son-of-BOSS transactions and prohibited non-participating taxpayers from taking their case to Appeals.[61] Those taxpayers wishing to test the merits of their particular case were told that "anyone who doesn't come forward can still take the IRS to court. In such instance, the government will vigorously purse the full tax due, applicable interest and the maximum penalty."[62] Taxpayers were also told not expect to settle court cases on terms "more favorable than those offered in the settlement initiative."[63]

The IRS estimates that approximately 78 percent of eligible taxpayers elected to take part in the son-of-BOSS settlement initiatives, but about 400 have indicated they will not participate.[64] The participation percentage could also decrease if some taxpayers who initially joined in the initiative do not sign closing agreements.[65] Thus, the "one-size-fits-all" Son-of-BOSS settlement initiative has deprived at least 400 taxpayers (fully one-third of eligible taxpayers) of the opportunity to have an Appeals Officer evaluate the specific facts and merits of their particular case. These taxpayers and the government must now incur the expense of litigating these cases. Further, there is no guarantee that the government will come away from this litigation with results that are better, or even comparable to, the settlement initiative terms.[66]

More recently, Appeals participated in an IRS news release dealing with tightening settlement terms for certain abusive tax shelter transactions.[67] The news release was in response to the government's victory in *Long-Term Capital Holdings v. United States*[68] and set forth

[60] 2002 TNT 194-34, statement of David B. Robison, IRS Chief of Appeals.

[61] Announcement 2004-46, 2004-21 I.R.B. 1. Son-of-BOSS transactions are described in Notice 2000-44, 2000-2 C.B. 255.

[62] IRS News Release, "IRS Offers Settlement for Son of Boss Tax Shelter," IR-2004-64 (May 5, 2004) (statement of IRS Commissioner Mark Everson).

[63] *Id*. (statement of IRS Chief Counsel Donald Korb).

[64] Sheryl Stratton, *IRS Officials Provide Shelter Initiative Update*, 2004 TNT 193-4, October 5, 2004.

[65] *See* Sheryl Stratton, *IRS Riding High on Shelter Enforcement Initiatives*, 2004 TNT 201-2, October 18, 2004.

[66] In *Black & Decker Corp. v. United States*, 94 A.F.T.R.2d 2004-6437 (D.Md., 2004), the court granted the taxpayer a full refund for an assessment involving the taxpayer's participation in a Code section 357(c) contingent liability transaction. These transactions were listed as tax shelters in Notice 2001-17, 2001-1 C.B. 730, and the IRS offered a global settlement initiative for these transactions in Rev. Proc. 2002-67,2002-43 I.R.B. 733. The taxpayer in *Black & Decker* had not been allowed to participate in the settlement initiative because the IRS did not believe the taxpayer had met the requirements for participation. The taxpayer then litigated the case and prevailed when the court held the taxpayer's particular contingent liability transaction had economic substance.

[67] IRS News Release, "IRS Tightens Position on Abusive Tax Shelter Settlement Terms," IR-2004-128 (Oct. 20, 2004).

[68] 2004-2 USTC P 50,351 (D.Conn., Aug 27, 2004)

new settlement guidelines requiring taxpayers to concede 100 percent of claimed loss or deductions and 50 percent of assessed penalties in certain lease stripping transactions. This news release contained statements by the IRS Commissioner, IRS Chief Counsel, LMSB Commissioner and the Chief of Appeals. One practitioner reacted to the news release by saying, "the announcement has more to do with Appeals agreeing to rattle sabers on behalf of the IRS Commissioner and less to do with rational analysis of the facts of the case by someone who is supposed to be serving the noble role of an independent administrative law judge."[69]

The National Taxpayer Advocate recognizes the problem with the recent proliferation of abusive corporate tax shelters and their effect on the Federal tax gap. The National Taxpayer Advocate also believes that Appeals can sustain well-reasoned and supported IRS examination adjustments and still maintain independence. In fact, Appeals has historically served as the "check and balance" on IRS enforcement, holding the IRS to enforcing the law correctly and properly.

The National Taxpayer Advocate is concerned, however, that Appeals' direct participation with IRS enforcement in these shelter settlement initiatives compromises Appeals independence in both fact and appearance. Appeals itself has emphasized the importance of separating itself from IRS enforcement:

> Effectiveness of [Appeals] depends a great deal upon the confidence and trust taxpayers have in its fairness, objectivity, and impartiality. *Appeals' mission is to resolve disputes; and this mission cannot be accomplished if, in either fact or appearance, it seems to be an extension of the Examination process.* If the appeals office is burdened with the responsibility to perfect the audit or unreasonably develop the issues in controversy, taxpayers will bypass the administrative process and deprive the Service of the opportunity to settle cases in non-docketed status. Therefore, Appeals must not be viewed by taxpayers as an arm of the Examination function or an adversary seeking to strengthen the government's case.[70]

Appeals participation in these initiatives has communicated the message that there is no possibility of an administrative resolution in shelter cases unless taxpayers are willing to accept the settlement terms set by IRS enforcement. The National Taxpayer Advocate also wonders if Appeals participation in these initiatives is also sending the message that Appeals has become an IRS Examination support function. These messages have two consequences. First, if affected taxpayers believe that the facts and circumstances of their particular case warrant a better settlement, they must bypass Appeals and proceed directly

[69] *See* Sheryl Stratton, *Appeals Tightens Screws on Shelter Investors*, 105 Tax Notes 487 (Oct. 25, 2004).

[70] IRS Document 7225, "History of Appeals" at 7-8 (Nov. 1987) (emphasis added).

to litigation. Second, and more significant, taxpayers in general may view Appeals as merely another arm of IRS enforcement and bypass the Appeals process in favor of litigation, or even noncompliance. Forcing taxpayers into these situations seems to be a curious action for an organization whose mission is to fairly resolve tax controversies without litigation. The National Taxpayer Advocate is concerned that if Appeals is perceived as a mere extension of IRS enforcement in a climate of increased enforcement, Appeals will begin to fail its historical mission.

IRS COMMENTS

The National Taxpayer Advocate is concerned that recent changes within Appeals operations undermine Appeals' ability to fairly and impartially resolve cases–generally called Appeals "independence". According to the TAS report, if Appeals independence is in doubt, taxpayers will lose confidence in the Appeals process and go elsewhere, i.e., litigation. We appreciate the Advocate's concern–in essence, she expresses support and confidence in the Appeals process. She recognizes the value Appeals brings to tax administration, and wants to preserve it.

Congress enacted RRA § 1001(a)(4) requiring the Commissioner to ensure an independent Office of Appeals "within the Internal Revenue Service". This qualification is very important. By placing Appeals **within** the Internal Revenue Service, Congress imposed inherent limitations on its independence. Hence, in defining Appeals' role, it is necessary to balance competing interests. For example, it makes clear that while Appeals should not be subordinate to other IRS functions, Appeals must still operate consistently with IRS policies, practices, and positions. Thus, consistent with this statutory provision, Appeals reports to the Commissioner, who is charged with the overall responsibility for administering the internal revenue laws. The structure supports Appeals independence.

Without some participation in multifunctional meetings and discussions where agency policy is set, Appeals would be operating in a vacuum with little or no understanding of the IRS's mission and goals. Appeals would then not be able to effectively serve as the IRS's administrative dispute resolution arm. In short, Appeals would not be operating **within** the IRS as required by Congress; rather, it would be functioning as an isolated entity.

Additionally, the new Appeals processes causing the Advocate's concern bring opportunities to better serve taxpayers with fair, correct, and timely case resolutions. They expand case resolution options–not eliminate them. For the first time in its history, Appeals has an integrated, national structure that reports directly to the Commissioner. Under this structure, customer satisfaction surveys show increased satisfaction with Appeals services.

Nevertheless, some concerns have been raised about these new case resolution approaches, as happens whenever new processes are rolled out. To ensure the careful and complete consideration of the concerns, the IRS asked the Treasury Inspector General for Tax Administration (TIGTA) to review Appeals to ensure the modernized structure and processes adhere to the intent of RRA 98. This audit is already underway.

ACCESS AND INDEPENDENCE CONCERNS

The TAS report indicates that if taxpayers believe they cannot reasonably access the Appeals process, or believe that Appeals will not give their case a fair and independent review, they will bypass Appeals and proceed to litigation or noncompliance. The IRS would agree if this were true; however, taxpayers do have access and confidence in our ability to resolve the dispute in a fair and impartial manner. The data supports this perspective.

The TAS report acknowledges that from fiscal year 2000 to FY04 Appeals receipts increased by 78 percent, from 55,431 to 98,677 cases. The report also notes that Appeals disposals have increased 89 percent during this period, from 55,088 to 103,946 cases. In FY 2004, cycle time dropped in all but one of Appeals major work streams. The IRS agrees that more work needs to be done to continue this positive trend. In addition to what is noted in the TAS report and for the first time in four years, Appeals resolved more cases than it received last year. Productivity gains, defined as the number of cases resolved per Appeals employee, were about 80 percent between FY00 to FY04. This data argues that taxpayers do not see major problems with accessing Appeals. Our customer satisfaction data reveals confidence in Appeals independence.

The TAS report questions Appeals' efforts to focus on reducing cycle time. The Advocate believes achieving these goals will come at the expense of full and fair consideration, especially for the low income or *pro se* taxpayer. Indeed, she says that the IRS has "made overt efforts to limit certain taxpayers' access to the Appeals process". The IRS does not agree—these initiatives help Appeals address taxpayer needs in several ways:

1. Appeals efficiency in resolving cases frees up resources to work with other taxpayers; and
2. Working cases at the appropriate employee grade level to their complexity enables Appeals to dedicate more personnel to taxpayer cases.

These efforts, then, enable Appeals to more fully address the specific issues in each taxpayer's case, rather than limiting them.

The IRS believes the focus on reducing cycle time does not come at the expense of full and fair consideration. Data reflects that taxpayers concur. Appeals most recent customer satisfaction survey, issued in September 2004, confirms that it retains taxpayers' overall confidence. Nearly two-thirds of the respondents (63 percent) indicated that they were satisfied with Appeals services; the proportion of dissatisfied customers dropped to less than one-quarter (23 percent). The remainder was neutral. The 8 percent increase in overall satisfaction from the prior period (3.3 to 3.6 on a five-point scale) is statistically significant indicating this is a genuine trend. The ratings for specific survey questions rose in 15 of the 17 categories over the prior period. Three of the four categories where Appeals achieved statistically significant improvement relate directly to issues raised in the TAS report–Appeals independence, adequacy of resources applied by Appeals, and fairness in resolving the case. This certainly contradicts the Advocate's concerns for each of these issues. In other words, Appeals is making steady progress in resolving disputes in a manner that meets the taxpayers' needs--even as it experiences increased receipts. While there remains room for improvement, the data shows Appeals is on the right track.

Campus Specialization Initiatives

The TAS report correctly identifies the various challenges and potential concerns about creating campus operations. Within its campus strategy, Appeals intends to create an environment that resolves disputes correctly and timely. If challenges come with these efforts, the IRS is confident we can overcome them.

One factor driving this campus strategy has been changing customer expectations. When a customer has a credit card problem, the customer can pick up the phone and resolve the matter immediately. When a prescription needs to be refilled, the customer wants to pick up the phone and give an automated reorder number and have the prescription filled.

Another factor is Appeals' experience in managing campus operations successfully since 1988. Employees at those campuses have long resolved centralized "S" docketed cases very effectively. The current campus strategy builds on this success.

By creating a flexible conferencing approach, all taxpayers are better served–both because their own case is resolved more effectively, and because Appeals' enhanced efficiency enables it to handle *all* cases effectively. The campus strategy means Appeals can have the resources ready and available to handle and resolve *each* and *every* case.

Appeals is committed to holding the right kind of conference for each case. Appeals believes that most taxpayers want easy and immediate access to Appeals–in a way that inconveniences them the least. The campus operations can support that. Appeals will always encourage taxpayers and practitioners to request the right kind of conference for the case. Where a letter properly articulates the issue–taxpayers should write a letter. Where a personal explanation of the matter will communicate the issues better–taxpayers can pick up the phone and discuss the issues in their case. Where there are complicated fact patterns and voluminous documentation to present–taxpayers should ask for a face to face conference. Appeals and the Taxpayer Advocate Service need to advise taxpayers to ask for the right type of conference for the type of case. The only caveat would always be that this should always be done before initiating significant settlement discussions with Appeals.

The TAS report raises a legitimate question about whether taxpayers will be allowed to have a face-to-face conference. Appeals is on record that if a face-to-face conference is requested Appeals will provide it–either through video conferencing or by transferring the case to a local field office for consideration. This is unlikely to be a major concern because taxpayers currently do not overwhelmingly request such conferences.

The IRS is troubled, however, by the TAS report's emphasis on face-to-face conferences as the only way to successfully resolve a dispute. The IRS believes this emphasis may, in fact, unnecessarily burden the very taxpayers about whom the Advocate is most concerned. The cost of commuting and lost wages for time spent getting to a local Appeals office are significant to the smaller, low income taxpayer. Access by phone is necessary for these individuals.

The IRS has kept statistics on the type of conference held only since 2/20/04. More than three-quarters (78 percent) of Appeals conferences (field and campus cases) since then have been through telephone or correspondence. Even in field offices, 73 percent have been resolved through telephone or correspondence. Recently in a "Tax Talk Today" show the IRS asked practitioners the question on how they were conferencing the cases. Three-quarters (75 percent) of them said their conferences were either by phone or by correspondence; they had no complaints or objections regarding access to Appeals.

The TAS report notes that Appeals campus efforts favor "processing and speed" over independence. The IRS does not agree. The goal is to get to the right answer 100 percent of the time wherever the case is worked. To ensure this focus, all Appeals employees receive the same training, oversight, quality review, or automation resources regardless of where they are located. The IRS is aware that there are issues unique to a campus operation. Appeals' strategy includes revised correspondence for campus cases. The training plan includes components on exercising independent judgment and effective telephone techniques, just as the TAS report recommends. Appeals has an on-the-job training component as well. Some of the Low Income Tax Clinic's (LITC) concerns are more likely the result of newer Appeals employees handling the case than because they are campus employees. Taxpayers concerned about the way their case is being handled in a campus location can raise these to the manager, just as in field offices.

The IRS is analyzing the quality of Appeals case resolution through the Appeals Quality Measurement System (AQMS). Those results are being separately measured for campus operation so that the IRS can ensure the same level of quality as field operations. Here are some results.

	Score
Current overall Appeals score	79
Range for campus operations	73-86
Range for field operations	71-86

This data shows that the Appeals' campus strategy not only allows all the offices to concentrate on the cases they do best, they do it with the same quality.

The TAS report expresses concern over the grade level of Appeals campus employees. In the IRS's experience, taxpayers want a knowledgeable tax professional handling their dispute. When employees are knowledgeable, well-trained and given the resources necessary to do their jobs–then their grade and even location are irrelevant. The goal is to get to the right answer in a timely manner. Appeals is doing that more and more.

The TAS report recommends that Appeals meet with LITC programs and the Taxpayer Advocacy Panel to discuss the effects of the campus strategy. Appeals currently meets with these groups and intends to continue such meetings in the future. The IRS wants to effectively serve all of its customers.

Ex Parte Communications

As ultimately enacted, § 1001(a)(4) of RRA 98 did not impose a comprehensive overhaul of Appeals' processes. Instead, it required the Commissioner to ensure an independent Office of Appeals within the Internal Revenue Service. It prohibited *ex parte* communications "to the extent such communications appear to compromise the independence" of Appeals. When considering the evolution of § 1001(a)(4) of RRA 98 during the 1998 legislative process and in light of Appeals longstanding methods of operation, it can be fairly concluded Appeals must be accorded a significant degree of independence from other IRS components. All within Appeals must be mindful to avoid ex parte communications with other IRS functions that might appear to compromise Appeals independence.

The TAS report states that the exceptions to *ex parte* communications provided in Rev. Proc. 2000-43 integrate Appeals into the IRS and weakens its independence. The report states that Appeals involvement in the tax shelter initiatives and its Fast Track strategies are the two clearest examples of this erosion of Appeals independence. The IRS disagrees because Appeals is invited by both the taxpayer and Compliance to participate in any fast track process. Appeals personnel do not operate in their traditional role and the case itself remains in Compliance's jurisdiction.

With regard to the *ex parte* waiver in settlement initiatives and the fast track programs, the prohibition against *ex parte* communications between Appeals Officers and other IRS employees does not apply. Since mediation is a process where each party caucuses with the mediator separately, *ex parte* communications are required.

Appeals personnel, in facilitating an agreement between the taxpayer and Compliance, are not acting in their traditional Appeals settlement role. Again, the case itself remains in Compliance's jurisdiction. The taxpayer's involvement is at their own election, not the government's. Taxpayers may opt out of either fast track program and exercise their traditional appeal rights, where *ex parte* prohibitions apply. As long as the taxpayer clearly understands the process their rights are protected and Appeals independence is not at issue.

The TAS report also expresses concern that knowledge gained during the fast track programs may serve to "compliance proof" Appeals' settlements prior to the traditional Appeals process. This has not been the IRS's experience with the large case program. Fast Track Settlement has been an effective means of enhancing communication between all related parties so they understand and accept the basis for the resolution.

Tax Shelter Issues

The TAS report notes concern that Appeals' direct participation with IRS compliance in tax shelter initiatives compromises Appeals independence in both fact and appearance. The IRS agrees that all IRS functions need to operate transparently to combat even the appearance of lack of independence. The IRS strongly disagrees, however, that Appeals independence is compromised.

Appeals' participation in developing global tax shelter settlement initiatives does not prevent Appeals from maintaining its independence or satisfying the goals of the provision restricting *ex parte* communications with Appeals. First, the issue management process focuses the IRS's attention and resources on selected transactions and issues generally, not on the facts of any particular taxpayer's case. This enables the IRS to share its collective expertise and knowledge, increasing the likelihood of achieving both the right result and consistent treatment. Appeals' participation provides the process with needed information and technical expertise that help evaluate the IRS's hazards of litigation and make informed decisions regarding settlement guidelines. Also, it allows Appeals to provide meaningful input into formulating the IRS's strategy for handling various types of tax shelters.

Second, and perhaps more importantly, including Appeals in the process furthers the chances that the IRS's global tax shelter settlement initiatives will be successful. When Appeals is not part of the global tax shelter settlement initiatives, taxpayers have less incentive to participate because they may anticipate a "better deal" by going to Appeals. This would undermine this approach's usefulness for handling tax shelter cases, depriving the IRS of an opportunity to resolve large numbers of these cases using fewer resources. This would also result in Appeals working at cross purposes to the objectives of the IRS as a whole. Appeals would not be functioning **within** the IRS, as contemplated and required by Congress. In short, an independent Appeals office is intended to assist the IRS in meeting its responsibilities to fairly and impartially administer the internal revenue laws, not undercut the Service's efforts to do so. When it participates in the issue management process, Appeals can positively influence the IRS's decision making from its unique vantage point. If Appeals were to operate completely outside of the system, as advocated in the TAS report, it would lose the ability to be part of the solution, as Congress envisioned.

Certainly, the current tax shelter settlement initiatives represent a new cross-functional effort by Appeals, Counsel and Compliance to carrying out their respective roles in tax administration. However, the critical piece to recognize is that within an "Issue Management Team" each function maintains its unique role (i.e. Compliance develops the facts, Counsel articulates the applicable legal arguments, and Appeals assesses the respective litigating hazards). The roles, procedures and operation of the team are clearly outlined in the "Process Guide for Combating Abusive Tax Transactions." It confirms that Appeals has neither assumed the roles and responsibilities of another function nor delegated or ceded its own.

Oral Request for Appeals

The TAS report states that the elimination of an oral request for an appeal in smaller cases creates an unreasonable burden on unrepresented taxpayers. While the IRS understands these concerns, it believes that the current procedures are appropriate and protects taxpayers' rights to easy access to Appeals. The IRS does not believe that this issue impacts on Appeals independence, the subject of this most serious problem.

To make it easier for a taxpayer to request a small case appeal and to ensure its timely consideration, Appeals has developed Form 12203, Small Case Request, a very brief, easily completed document. This "tear off" form will be included in publications sent to the taxpayer with each proposed adjustment. Form 12203:

- Verifies that the taxpayer indeed wants to go to Appeals;
- Frames the issues so both Compliance and Appeals understand the reasons for the protest;
- Enables Compliance to consider and perhaps even concede the issues based on the taxpayer's stated position; and
- Allows Appeals to assign the work and plan for our conferencing immediately upon receipt of the case rather than waiting for taxpayer contact.

The small case request form is a much more reliable way to request an appeal. Many taxpayers do not respond nor provide any documentation regarding their issues. While the small case request doesn't guarantee the presentation of documentation, it helps to articulate the disagreement. The Advocate supports implementation of the small case request (Form 12203). This process protects the small case taxpayer much more than any potential concern raised by eliminating the oral request for appeal.

The IRS has had success with similar appeal request forms specific to collection due process and collection appeals cases.

Conclusion

In summary, Appeals structural alignment strongly supports its independence within IRS and customer satisfaction results indicate that Appeals is getting to the right answer at the right time more and more often. Appeals new processes allow taxpayers to resolve their disputes at the earliest time with full confidence that traditional Appeals options remain available to them if needed.

TAXPAYER ADVOCATE SERVICE COMMENTS

Based on the IRS response, it appears that the National Taxpayer Advocate and Appeals agree that the Appeals process has great potential to resolve controversies inexpensively without litigation and to improve voluntary compliance. The process has the potential to benefit both the government and taxpayers. However, because participation in the Appeals process is voluntary, taxpayers will not use it unless they can easily request an appeal and participate in the process, and feel assured that Appeals will give their case fair and independent consideration – a de novo *review of issues. Without full confidence in Appeals, taxpayers will be more likely to resort to litigation or noncompliance. For these reasons, ready access to the Appeals process and taxpayer perceptions that Appeals is fair and independent are critical to its mission.*

Appeals' efforts to reduce the cost of the program, exceptions to the ex parte *rules, Appeals' participation in forming IRS enforcement strategies and tax shelter settlement initiatives, and eliminating the right to an oral Appeal request – all of these initiatives have the potential to damage Appeals' ability to fulfill its mission if these efforts threaten either access or perceptions of Appeals' independence. The National Taxpayer Advocate raises these issues precisely because she believes an independent Appeals function is vital to fair tax administration.*

The IRS asserts that including Appeals in the planning of the IRS' global tax shelter settlement initiatives while denying taxpayers their ability to seek an appeal in these cases prevents Appeals from "working at cross purposes to the objectives of the IRS as a whole." The National Taxpayer Advocate believes that Appeals can still adhere to IRS strategic objectives, such as cracking down on corporate technical tax shelters and abusive tax schemes, without compromising its ability to decide *taxpayer cases on their specific facts and circumstances. Contrary to the IRS' suggestion, it is possible that many taxpayers will participate in shelter initiatives in order to obtain certainty while others will not litigate if a reasonable facts-and-circumstances settlement can be reached with Appeals. It is also possible for Appeals to exercise its independent judgment in making a* de novo *review of the case and still come out very closely aligned with IRS Examination's position. If the IRS' position is carefully and correctly reasoned, then Appeals can sustain it without fear of compromising its independence.*

There are three reasons why the IRS might want to deny taxpayers access to Appeals in tax shelter settlement initiatives. First, the IRS may believe that Appeals cannot be trusted to uphold the IRS where appropriate. Second, the IRS may fear that the IRS' position cannot withstand an independent administrative de novo *review. Third, the IRS may have concluded that the transactions are so per se outrageous that it doesn't want to waste Appeals resources on them. This latter approach may be appropriate where all of the cases follow the same fact pattern. But it is the experience of the National Taxpayer Advocate that once you look beyond "page one" of many of these cases, you come up with different sets of facts and circumstances, and different taxpayer situations. In fact, the IRS is still struggling today with many cases in which taxpayers chose not to participate in the earlier tax shelter settlement initiatives from 20 years ago. Moreover, the IRS has never done any rigorous analysis of just how many administrative and judicial resources it conserves as a result of its one-size-fits-all settlement initiatives.*

In its response, the IRS seems to have defined away the role of an independent de novo *administrative review. The IRS states that "an independent Appeals office is intended to assist the IRS in meeting its responsibilities to fairly and impartially administer the internal revenue laws, not undercut the Service's efforts to do so." This extraordinary statement declares that Appeals exists at and for the convenience of the IRS and literally writes the needs of taxpayers out of the picture. It is also contrary to Treasury Regulations that mandate that Appeals exercise "strict impartiality between the taxpayer and the Government."*[71]

Notwithstanding the IRS' statements, it is possible for Appeals to take a position different from the IRS' general administrative position in specific cases without necessitating its move outside the IRS. Indeed, that independent facts-and-circumstances analysis was the genesis for Appeals' creation back in 1927. It is both possible and necessary for Appeals to adopt an approach that is somewhere between totally inside and outside the IRS – the role of the neutral, administrative appeal function.

One reasonable explanation for Appeals' placement within the IRS is to provide taxpayers exposed to the Appeals process with the impression that the IRS itself (rather than some independent quasi-judicial body) is fair and reasonable, thereby promoting voluntary compliance among the general population. The National Taxpayer Advocate believes that the IRS response reads too much into RRA 98's language requiring the Commissioner to ensure an independent Office of Appeals within

[71] Treas. Reg. § 601.106(f)(1).

the IRS. As explained in the TAS report, Appeals has been part of the IRS since 1927, when it was established to provide a de novo *review of tax disputes and lower the number of taxpayers seeking such* de novo *review in the Board of Tax Appeals. The statutory language is merely a statement of structural convenience, not an imposition of limits on Appeals' independence, as the IRS suggests. In fact, the legislative history of RRA 98 indicates that Congress specifically envisioned an Appeals function independent of IRS enforcement:*

> *One of the major concerns we've listened to throughout our oversight initiative – a theme that repeated itself over and over again – was that the taxpayers who get caught in the IRS hall of mirrors have no place to turn that is truly independent and structured to represent their concerns. With this legislation, we require the agency to establish an independent Office of Appeals – one that may not be influenced by tax collection employees or auditors.* [72]

This statement emphasizes the point Appeals itself made in 1987: taxpayers will bypass Appeals it is viewed as an "arm of the Examination function or an adversary seeking to strengthen the government's case." [73]

The National Taxpayer Advocate agrees that, in addition to independence, efficiency is an important component of Appeals' success. She is concerned, however, about efficiency measures that come at the expense of fairness or quality. As pointed out in the TAS report, Appeals' Campus Specialization Initiative appears to present the potential for increased efficiency at the possible expense of quality and fairness. In fact, the IRS response on this issue raises new concerns with Campus centralization.

The National Taxpayer Advocate is especially concerned by the IRS' likening the resolution of tax disputes to resolving a credit card problem or ordering a prescription. Neither of these transactions involves government action, or possesses the potential for serious consequences to the caller as the does the failure to obtain a fair or impartial decision in a tax dispute based on all the facts and circumstances. We are certainly not suggesting that face-to-face meetings are the only approach to Appeals conferences. Indeed, many taxpayers may be happy to have a telephonic conference. But they must be given a choice, and that choice must be meaningful. The choice will not be meaningful if the taxpayer must choose between having an immediate conference over the phone or a face-to-face conference two or three months later (because of lower field office staffing or delay in transferring the files). As Appeals' own customer satisfaction data show, taxpayers want a speedy resolution to their tax problems. So the average taxpayer will take speed over delay, even if a face-to-face hearing is to his or her advantage.

The National Taxpayer Advocate is also concerned by the IRS' statement that if taxpayers want to talk with Appeals, they can pick up the phone. This is one of the specific drawbacks of the campus environment. In the field, Appeals Officers call taxpayers or their representatives to get information

[72] 144 Cong. Rec. S4182 (1998).

[73] IRS Document 7225, "History of Appeals," 7-8 (Nov. 1987).

needed to make a decision or settlement offer. This interactivity and "reaching out" has significant, positive results for low income taxpayers and is one of the reasons Appeals' often reverses decisions made by IRS examination employees in EITC and other cases. Campus employees, on the other hand, are routinely instructed not to call taxpayers. If this approach is adopted by Campus Appeals officers, taxpayers will be harmed. Campus Appeals officers must be encouraged to pick up the phone and call taxpayers to flesh out facts and clear up issues. And they must be trained to recognize when it is appropriate or even necessary to do so.[74]

After expressing these concerns, however, the NTA commends Appeals for:

- *Requesting the Treasury Inspector General for Tax Administration (TIGTA) to audit Appeals' adherence to the intent of RRA 98;*
- *Making strides in improving its productivity;*
- *Training its employees to use independent judgment and effective telephone techniques;*
- *Soliciting feedback from LITC programs and the Taxpayer Advocacy Panel; and*
- *Developing Form 12203, Small Case Request, which provides taxpayers with a "tear off" form for requesting an Appeals conference.*

These developments are likely to facilitate program improvements and increase the likelihood that taxpayers will continue to use Appeals. However, Appeals should do more to give taxpayers access to and confidence in the Appeals process and to protect its own independence within the IRS.

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations:

Access to Appeals

- *Appeals should permit oral appeals to be requested as provided by existing regulations. It should electronically document such requests and prepare computer generated acknowledgement letters. Although we applaud the development of Form 12203, Small Case Request, and believe that it will reduce burden for some taxpayers, requiring any form of written request is more burdensome than an oral request, especially for taxpayers for whom English is a second language. In this, as in many other aspects of tax administration, no one size fits all.*[75]

[74] In its response, the IRS cites a survey of practitioners watching "Tax Talk Today" for the proposition that practitioners have no complaints or objections to phone or correspondence communications with Appeals. This data is irrelevant to the National Taxpayer Advocate's concerns, which focus on the ability of *unrepresented taxpayers* to communicate with Appeals officers. Her long experience representing middle and low income taxpayers who have attempted, on their own, to navigate the IRS, causes her to question IRS' position that placing Appeals in a campus, correspondence-driven environment will have no impact on access to the Appeals function.

[75] It is disturbing that the IRS is ignoring the clear requirement of Treasury regulations with respect to oral appeal requests. Treas. Reg. § 601.106(a)(1)(iii)(a) provides that "an oral request is sufficient to obtain Appeals consideration in (1) all office interview or correspondence examination cases or (2) a field examination case if the total amount of proposed additional tax including penalties, proposed overassessment or claimed refund . . . is $2,500 or less for any taxable period. No written protest or brief statement of disputed issues is

- *Appeals should revise its procedures so that Appeals officials verbally inform every taxpayer making an Appeal that they have the right to a face-to-face appeals conference upon request. This will promote participation in the Appeals process by unrepresented taxpayers, who might not otherwise know that they can request an oral conference. Once so informed, taxpayers can decide for themselves whether it is uneconomical, in time or money, to elect such a hearing. Of course, Appeals must ensure that there is sufficient staffing in the field offices to promptly handle cases in which a face-to-face hearing is requested.*
- *IRS should research the effectiveness of its tax shelter global settlement initiatives to determine whether, in fact, they resolve taxpayer cases, from assessment to collection of tax due, in a more expeditious and less expensive manner than the traditional controversy approach that allows for access to Appeals as well as litigation.*

Appeals Independence

- *Appeals should limit its participation in enforcement oriented partnerships with IRS operating divisions, including the development of tax shelter settlement initiatives, to an advisory role and ensure that the right to an administrative* de novo *appeal is not curtailed in such cases. Moreover, Appeals officials should avoid public statements indicating that it has prejudged any cases or issues.*
- *In connection with its mediation programs, Appeals should revise its* ex parte *rules to prohibit Appeals from discussing the substantive issues with compliance before Appeals has discussed them with the taxpayer or, alternatively, the parties have discussed them jointly. This approach may reduce the perception that Appeals has prejudged the case.*

Appeals' Quality and Participation Rate

- *Appeals should rapidly follow through with its plans to develop measures to evaluate the effectiveness of its CSI and Right Work/Right Employee Strategies, and implementation of its mentoring program.*
- *Appeals should re-evaluate its definition of complexity to ensure that complex cases are worked by appropriately trained and skilled personnel, regardless of whether the case originates in a campus or involves a low income or EITC taxpayer.*

required." Regulations have the force and effect of law on both taxpayers and the IRS. If the IRS can ignore regulations, then, as a practical matter, the IRS has a way to circumvent Treasury directives and guidance with which the IRS does not agree. Certainly the IRS cannot comply with those regulations that provide an advantage to the government while ignoring those that grant taxpayers additional rights and protections.

PROBLEM

TOPIC E-18 MOST SERIOUS PROBLEM: IRS MEDIATION PROGRAMS

RESPONSIBLE OFFICIALS

David B. Robison, Chief Appeals
Kevin M. Brown, Commissioner, Small Business/Self-Employed Division

DEFINITION OF PROBLEM

Alternative dispute resolution (ADR) techniques such as mediation[1] have "yielded decisions that are faster, less expensive, and less contentious;… can lead to more creative, efficient, and sensible outcomes;… [and] effective use of such procedures, will enhance the operation of the Government and better serve the public."[2] On this basis, Congress directed the IRS to prescribe procedures under which a taxpayer or the IRS' Appeals function may request mediation.[3] The IRS has two primary mediation programs, post-Appeals mediation and Fast Track Mediation (FTM).[4] The FTM process involves mediation between the IRS examination or collection division and the taxpayer after the parties have failed to reach a settlement but while the case is still under the jurisdiction of examination or collection.[5] Post-Appeals mediation involves mediation between Appeals and the taxpayer after negotiations have failed to reach a settlement and the case is still in Appeals' jurisdiction.[6]

Evaluation is a critical component of any government mediation program.[7] However, the IRS has not fully evaluated whether its programs are achieving the benefits identified by Congress or how the programs could be improved, as recommended by the Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA).[8] Among the areas of concern (in need of further evaluation) are:

- ***Education and Publicity.*** At present, the IRS is not measuring the effectiveness of its efforts to educate IRS personnel (*e.g.*, examination, collection and Appeals employees), taxpayers, or tax professionals about its mediation programs.

[1] Mediation is a process by which a neutral mediator assists disputing parties to reach a voluntary resolution of the dispute. *See generally*, Kimberlee K. Kovach, *Mediation Principles and Practice*, 3rd ed., West, 2004, 26-28.

[2] *See* Administrative Dispute Resolution Act, Pub. L. No. 101-552, 104 Stat 2736 § 2 (Nov. 15, 1990) (reenacted in 1996).

[3] IRC § 7123(b).

[4] Other IRS mediation procedures exist, for example, IRS Chief Counsel has procedures for utilizing mediation to resolve docketed cases. IRM 35.3.20 (Rev. 1-24-1996). These other procedures are not the focus of this discussion.

[5] Rev. Proc. 2003-41, 2003-25 I.R.B. 1047 (Jun. 3, 2003).

[6] Rev. Proc. 2002-44, I.R.B. 2002-26 (Jun. 7, 2002).

[7] *See* Department of Justice/Federal Alternative Dispute Resolution Counsel, Evaluation of Federal ADR Programs, 65 Fed. Reg. 59,200, 59,208 (Oct. 4, 2000); Jeffrey M. Senger, *Federal Dispute Resolution, Using ADR with the United States Government*, Jossey-Bass, 2004, Chapter 10. *See also* Government Performance and Results Act of 1993, Pub. L. No. 103-62, 107 Stat. 285 (Aug. 3, 1993) (requiring an evaluation of all government programs exceeding certain thresholds).

[8] *See* General Accounting Office, *IRS Initiatives to Resolve Disputes Over Tax Liabilities*, GAO/GGD-97-71, 10-15 (May 9, 1997); Treasury Inspector General for Tax Administration, *Taxpayers Should Be Informed of the Benefits of the Fast Track Mediation Program*, Reference No. 2002-10-070, 6-7 (March 29, 2002).

- ***Exclusions from IRS Mediation.*** Many types of disputes are excluded from IRS mediation (such as offer in compromise issues worked in a campus), without any evaluation of whether mediation might prove effective in such cases.
- ***IRS Decision Making Authority.*** In many cases, IRS participants in Fast Track Mediation do not have authority to resolve cases on the basis of "hazards of litigation."[9]
- ***Conflict of Interest and Confidentiality Concerns.*** The IRS mediation programs require the use of an IRS employee as a mediator, potentially producing conflict of interest and confidentiality concerns that may reduce the programs' effectiveness and deter taxpayers from utilizing them in the first place.
- ***IRS Mediator Training.*** IRS mediators do not receive frequent mediation experience or regular continuing education in mediation.

BACKGROUND

Benefits of Mediation

Congress has determined that in comparison to litigation, mediation and other forms of ADR offer a more prompt and inexpensive means of resolving disputes.[10] Various government agencies have demonstrated the value of ADR. For example, the Department of the Air Force used ADR in over 100 contract disputes in recent years and 90 percent have been settled.[11] ADR reduced the average time to process Armed Services Board of Contract Appeals cases by 50 percent, saving $40,000 per case involving less than $1 million and $250,000 per case involving more than $1 million.[12] The Army Corps of Engineers, which resolved 95 percent of cases taken to ADR, reduced its caseload of both contract claims and appeals by 80 percent.[13] Faced with over 14,000 formal employment-related complaints per year, the United States Postal Service adopted a workplace mediation program that resolved over 80 percent of its cases, reduced complaints by 30 percent, saved millions in legal costs, and resulted in job satisfaction gains.[14]

9 The term "hazards of litigation" refers to the ability to settle a case based upon the uncertainty of the outcome in litigation. *See* IRM 8.6.1.3 (Rev. 12-18-2001).

10 *See* Administrative Dispute Resolution Act, P.L. 101-552, 104 Stat 2,736 § 2 (Nov. 15, 1990) (reenacted in 1996). The IRS' Appeals process may be regarded as negotiation, which may be a form of ADR. However, the GAO has observed that "[u]nlike the 1990 act, the 1996 act did not include a reference to 'settlement negotiations' in the list of ADR techniques. The deletion was made to clarify Congress' intent to encourage the use of neutral third-party methods. According to ACUS [the Administrative Conference of the US], settlement negotiations do not use a neutral third party, and do not constitute an 'alternative' resolution method because agencies already had been using them." General Accounting Office, *IRS Initiatives to Resolve Disputes Over Tax Liabilities*, GAO/GGD-97-71, 6 (May 9, 1997).

11 Jeffrey M. Senger, *Federal Dispute Resolution, Using ADR with the United States Government*, Jossey-Bass, 2004, 4-5, 154-155.

12 *Id.*

13 *Id.*

14 *See* Mickey Meece, *Companies Adopting Postal Service Grievance Process*, N.Y. Times Mgmt, Sept. 6, 2000, *excerpts reprinted* in Lisa B. Bingham, *Mediation at Work: Transforming Workplace Conflict at the United States Postal Service*, (Oct. 2003), 6 (available at http://www.businessofgovernment.org/pdfs/Bingham_Report.pdf).

Recent Legislation and IRS Mediation Initiatives

In 1990, Congress, recognizing the potential benefits of ADR, passed the Administrative Dispute Resolution Act (ADRA), expressly authorizing all federal agencies to use ADR techniques and directing them to adopt ADR policies in consultation with an interagency committee.[15] In 1991, President George H.W. Bush signed Executive Order 12778, further encouraging federal agencies to utilize ADR where practical.[16] The ADRA and Executive Order 12778 both apply to the Internal Revenue Service.[17]

Between 1990 and 1997, the IRS initiated several dispute resolution programs.[18] Among these was a pilot of the post-Appeals mediation program for issues that were in the Appeals administrative process and not docketed in court.[19] However, this pilot was limited to disputes meeting large dollar thresholds.

In 1998, Congress codified existing IRS mediation procedures and eliminated the dollar thresholds so that post-Appeals mediation would be available for disputes of all sizes.[20] In response, the IRS extended the pilot program and in 2002 formally established the post-Appeals mediation procedures.[21] The IRS also expressly adopted a policy to support the development and use of ADR techniques to efficiently prevent and resolve disputes.[22]

In 2001, the IRS' Large and Mid-Size Business (LMSB) Division launched a Fast Track Dispute Resolution Pilot Program to expedite case resolution and resolve outstanding issues early in the course of examinations without transferring the cases to Appeals.[23] This program had two options: FTM and Fast Track Settlement (FTS). Under FTM, an

[15] Administrative Dispute Resolution Act, Pub. L. No. 101-552, 104 Stat 2,736 (Nov. 15, 1990) (reenacted in 1996 by Pub. L. No. 104-320 as the Administrative Dispute Resolution Act of 1996 and codified at 5 USC 571, *et seq.*).

[16] Executive Order 12778, 56 Fed. Reg. 55,195 (Oct. 23, 1991).

[17] *See* FSA 19920-326-2 (Mar. 26, 1992) (as modified by FSA 1992-0720-1 (Jun. 4, 1992)).

[18] *See* General Accounting Office, *IRS Initiatives to Resolve Disputes Over Tax Liabilities*, GAO/GGD-97-71, Appendix II (May 9, 1997) (describing the dispute resolution initiatives begun by IRS between 1990 and 1996).

[19] Announcement 95-86, I.R.B. 1995-44 (Oct. 13, 1995); Announcement 97-1, I.R.B. 1997-2, (Dec. 12, 1996); Announcement 98-99, I.R.B. 1998-46 (Oct. 30, 1998) (extending the pilot post-Appeals mediation program).

[20] *See* S. Rep. 105-174 (April 22, 1998) (stating: "The Committee also believes that mediation, binding arbitration, early referral to Appeals, and other procedures would foster more timely resolution of taxpayers' problems with the IRS. In addition, the Committee believes that the ADR process is valuable to the IRS and taxpayers and should be extended to *all* taxpayers." (Emphasis added)). *See also* IRC § 7123(b).

[21] *See* Rev. Proc. 2002-44, I.R.B. 2002-26 (Jun. 7, 2002) (formally establishing post-Appeals mediation procedures).

[22] *See* Policy Statement P-8-1, IRM 1.2.1.8.1 (Rev. 11-4-1998) (stating: "Pursuant to the Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105-206, and Treasury Directive 63-01, this Policy Statement reaffirms the principles of the Appeals administrative dispute resolution process… The Service supports the development and use of alternative dispute resolution (ADR) techniques by Appeals to create an administrative forum, independent of compliance functions, to efficiently prevent or resolve disputes. Appeals is encouraged to survey its customers and expand ADR test programs to enhance taxpayer service."). In addition, it is Appeals' mission to resolve tax controversies without litigation. *See* IRM 8.1.1.1 (Rev. 2-1-2003).

[23] Notice 2001-67, I.R.B. 2001-49 (Nov. 14, 2001). The IRS's Small Business Self Employed Division and Appeals function had been testing FTM since June 2000 and the tests confirmed that the process could shorten the time it takes to resolve a dispute. IR-2002-80 (Jun. 26, 2002).

Appeals Officer or Appeals Team Case Leader who had received mediation training would act as a mediator to help LMSB and the taxpayer resolve factual issues, but could not settle the case on behalf of the government.[24] Under FTS, an Appeals Team Case Leader would help the taxpayer and LMSB resolve both factual and legal issues. Although FTS is similar to FTM, FTS is not mediation because in FTS Appeals is acting as a co-negotiator with LMSB on behalf of the government and has the authority to settle the case using Appeals' normal "hazards of litigation" settlement authority (which exceeds the IRS examination division's typical settlement authority). However, under either procedure, LMSB would retain ownership of the case and the taxpayer would retain all the usual rights to appeal unagreed issues. In 2003, the IRS formally established FTS and FTM, with the Small Business/Self Employed (SBSE) Division and Appeals jointly administering FTM and LMSB and Appeals jointly administering FTS.[25]

Some of the benefits achieved by other government entities are evident in IRS mediation programs. For example, IRS programs require less paperwork than the regular Appeals process or litigation. In FTM, each party prepares a brief "summary of issues" document for the mediator, but the taxpayer is not required to submit a formal protest, as he or she would in Appeals.[26] Similarly, in post-Appeals mediation, each party prepares a "discussion summary,"[27] which is much less involved than the legal brief that they would draft for litigation.

Post-Appeals mediation and FTM also resolve issues more quickly than regular IRS procedures. In FTM, issues are resolved within 30-40 days on average,[28] as compared to an average of 261 days (in FY 2004) for the normal Appeals process.[29] In post-Appeals mediation, issues are resolved within 144 days on average, as compared to litigation, which can take years.[30]

[24] Appeals officer mediation training was designed and delivered with input from the Federal Mediation and Conciliation Service. *See* Treasury Inspector General for Tax Administration, *Taxpayers Should be Informed of the Benefits of the Fast Track Mediation Program*, Reference No. 2002-10-070, 3 (March 29, 2002).

[25] *See* Rev. Proc. 2003-40, 2003-25 I.R.B. 1044 (Jun. 3, 2003) (establishing FTS to be jointly administered by LMSB and Appeals); Rev. Proc. 2003-41, 2003-25 I.R.B. 1047 (Jun. 3, 2003) (establishing FTM to be jointly administered by SBSE and Appeals).

[26] Rev. Proc. 2003-41, 2003-25 I.R.B. 1047, § 4.03 (Jun. 3, 2003). Upon completion of FTM, the FTM Appeals Official prepares a brief Fast Track Mediator's Report and submits a copy to each party. Rev. Proc. 2003-41, *supra*, § 6.05.

[27] Rev. Proc. 2002-44, I.R.B. 2002-26, § 5.09 (June 7, 2002). At the end of the post-Appeals mediation process, the mediator prepares a brief report and submits a copy to each party. Rev. Proc. 2002-44, *supra*, § 5.15.

[28] *See* General Appeals, FTM Technical and Procedural Guidelines 1 (10/8/2003). In a sample of FY 2003 cases, IRS estimated that IRS and/or taxpayers could have saved 238 days of processing time on average by utilizing FTM, even though sampled FTM cases took 54 days on average to complete. Memorandum from SB/SE Director, Reporting Compliance to SB/SE Acting Deputy Director, Compliance Field Operations and Compliance Policy Executives, regarding Guidance to the Field on the Effective Use of Fast Track Mediation for Unagreed Examination Cases, 2 (May 27, 2004).

[29] Director, Appeals Tax Policy and Procedures (SBSE and W&I), Appeals Inventory Report AIR-One, Measures and Analysis - National Consolidated, FY 2004 (reflecting cycle time for nondocketed cases closed during FY 2004).

[30] E-mail response to TAS Information Request by Director, Technical Services, Appeals (Sept. 23, 2004).

Further, taxpayers using IRS mediation programs have been reasonably satisfied.[31]

ANALYSIS OF PROBLEM

Taxpayer Utilization of IRS Mediation Programs

Notwithstanding the benefits of mediation, only 112 FTM cases (less than one percent of Appeals' case receipts) were closed in FY 2004.[32] In an IRS sample of 238 unagreed field and office examination cases during FY 2003, 91 percent of the cases were eligible for FTM but none utilized it.[33] A TIGTA report estimated that only four percent of eligible taxpayers (56 out of 1,356) participated in the pilot FTM program during a recent one-year period.[34] Similarly, 3,430 Appeals cases were disposed of under IRS Counsel's jurisdiction in FY 2004,[35] but only 24 taxpayers requested post-Appeals mediation and 3 of those requests were denied.[36]

IRS mediation programs will not fully achieve their laudable goals unless a greater percentage of taxpayers that have disputes with the IRS use them.[37] Increasing the use of mediation will require the IRS to minimize the number of taxpayers and issues excluded from the programs, effectively communicate their existence and utility to taxpayers,[38] and maximize their effectiveness in quickly resolving disputes without unnecessary risk (*e.g.*, risk that taxpayer confidentiality may be breached).

Education and Publicity

The IRS has not fully evaluated the effectiveness of its efforts to publicize and educate internal and external stakeholders about the existence and utility of its mediation pro-

[31] On average FTM participants gave the FTM program a score of 4.2 out of 5 when rating their overall satisfaction with the program. Memorandum from SB/SE Director, Reporting Compliance to SB/SE Acting Deputy Director, Compliance Field Operations and Compliance Policy Executives, regarding Guidance to the Field on the Effective Use of Fast Track Mediation for Unagreed Examination Cases, 2 (May 27, 2004).

[32] E-mail response to TAS Information Request by Appeals, Director, Tax Policy and Procedure (LMSB/TEGE) (Nov. 2, 2004).

[33] Memorandum from SB/SE Director, Reporting Compliance to SB/SE Acting Deputy Director, Compliance Field Operations and Compliance Policy Executives, regarding Guidance to the Field on the Effective Use of Fast Track Mediation for Unagreed Examination Cases, 1 (May 27, 2004).

[34] *See* Treasury Inspector General for Tax Administration, *Taxpayers Should be Informed of the Benefits of the Fast Track Mediation Program*, Ref. No. 2002-10-070, 4 (March 29, 2002). The report also estimated that 26,000 taxpayers would be eligible annually under expanded criteria recommended by the FTM team.

[35] Director, Appeals Tax Policy and Procedures (SBSE and W&I), Appeals Inventory Report AIR-One, Measures and Analysis - National Consolidated, FY 2004.

[36] E-mail response to TAS Information Request by Appeals, Director, Tax Policy and Procedure (LMSB/TEGE) (Nov. 8, 2004).

[37] The success of the United State's Postal Service's mediation programs is attributed, in part, to management's evaluation of the program based upon the number of persons utilizing it rather than the number of settlements, which avoids institutional incentives to discourage participation by persons with difficult cases. *See* Lisa B. Bingham, *Mediation at Work: Transforming Workplace Conflict at the United States Postal Service* (Oct. 2003) (available at http://www.businessofgovernment.org/pdfs/Bingham_Report.pdf).

[38] *See* Treasury Inspector General for Tax Administration, *Taxpayers Should be Informed of the Benefits of the Fast Track Mediation Program*, Reference No. 2002-10-070 (March 29, 2002) (recommending additional measures to more effectively communicate the existence of FTM to taxpayers).

grams. Members of Appeals have been discussing mediation programs at compliance group meetings, IRS Nationwide Tax Forums, American Bar Association, Tax Executive Institute, and various other CPA and practitioner liaison meetings.[39] The programs are described in a few IRS publications.[40] Compliance employees are also supposed to describe FTM to taxpayers after completing an examination or collection determination.[41] However, TIGTA indicates that compliance employees have not always done this on a consistent basis.[42] The IRS has not determined whether its employees consistently encourage taxpayers to utilize FTM or post-Appeals mediation. Nor has it determined whether the programs are known to taxpayer representatives, and whether low utilization is due to a lack of information or a conclusion by taxpayers or practitioners that the programs are unlikely to be useful (*e.g.*, because of bias among IRS mediators) or are risky (*e.g.*, because of confidentiality concerns). If efforts to publicize IRS mediation programs are ineffective, the IRS may not be obtaining the time and cost savings that might otherwise be possible.

Exclusions from IRS Mediation

The following cases and issues are excluded from post-Appeals mediation:[43]

- Issues designated for litigation or docketed in any court;
- Collection cases;
- Issues for which mediation would not be consistent with sound tax administration (*e.g.*, issues governed by executed closing agreements, by *res judicata*,[44] or controlling Supreme Court precedent);
- Frivolous issues; and
- Cases where the taxpayer did not act in good faith during settlement negotiations (*e.g.*, failure to respond to document requests, failure to respond timely to offers to settle, and failure to address arguments and precedents raised by Appeals).

[39] E-mail response to TAS Information Request by Director, Technical Services, Appeals (Jul. 19, 2004). Appeals is also developing a DVD that will include a discussion of mediation as one of several topics. *Id.*

[40] FTM is described in Publication 3605, *Fast Track Mediation – A Process for Prompt Resolution of Issues*, and mentioned in Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, Publication 3498, *The Examination Process*, Publication 594, *The Collection Process*, and Publication 4203, *Resolving Disputes: Appeals processes and Fast Track Mediation*–CD-ROM. Both FTM and post-Appeals mediation are briefly described in Publication 4167, *Introduction to Fast Track Mediation, Fast Track Settlement, and Post Appeals Mediation*.

[41] *See* General Appeals, FTM Technical and Procedural Guidelines 4 (10/8/2003) (indicating that Compliance employees are supposed to offer FTM to taxpayers upon completion of the examination/collection determination); IRM 4.31.5.15.3 (05-31-2004). However, the IRM is not always clear in this regard. For example, it says that revenue officers "may" offer the taxpayer the option of using FTM in connection with CDP cases. IRM 8.7.2.3.1.1 (Rev. 5-27-2004).

[42] During a period in 2001, TIGTA found that only 40 percent of the compliance employees that it interviewed had offered FTM to qualified taxpayers. Treasury Inspector General for Tax Administration, *Taxpayers Should Be Informed of the Benefits of the Fast Track Mediation Program*, Reference No. 2002-10-070, 4 (March 29, 2002).

[43] Rev. Proc. 2002-44, *supra*, § 5.03.

[44] *Res judicata* refers to an issue that has been definitively settled by judicial decision. *Black's Law Dictionary* 1312 (7th ed. 2000).

The following issues and cases are excluded from Fast Track Mediation:[45]

- Issues for which resolution will depend on an assessment of the hazards of litigation;
- Issues designated for litigation or under consideration for designation for litigation;
- Issues for which there is an absence of legal precedent, conflicts between circuit courts of appeal, or are included in the Technical Advisor Program or in the Appeals Technical Guidance Program (*i.e.*, where the nationwide coordination of issues is desirable because the potential exists for setting adverse precedent contrary to the best interests of the IRS);
- Issues for which the taxpayer has submitted a request for competent authority assistance or the simultaneous Appeals/Competent Authority procedure;
- "Whipsaw" issues (*i.e.*, issues for which resolution with respect to one party might result in inconsistent treatment in the absence of the participation of another party);
- Cases worked at a campus (an IRS processing center);
- Collection Appeals Program cases (*e.g.*, liens, levies and seizures, and installment agreement terminations);[46]
- Automated Collection System cases;
- Frivolous issues;
- Issues for which mediation would not be consistent with sound tax administration (*e.g.*, issues governed by executed closing agreements, by *res judicata*, or by controlling precedent);
- Cases in which the taxpayer has failed to respond to IRS communications and has not previously submitted documentation for consideration by the examiner;
- Method of accounting issues; and
- Effective tax administration issues.[47]

The IRS has not fully explained the basis for excluding so many types of cases and issues from its mediation processes. For example, no reason has been given for the exclusion of all collection cases from post-Appeals mediation.[48] Campus cases, such as Offer in Compromise (OIC) and Automated Collection System (ACS) cases, are excluded from FTM because most would not have had managerial involvement and they are worked in centralized campus locations, making it difficult for all parties to be present for mediation.[49]

[45] Rev. Proc. 2003-41, *supra* § 3.02.

[46] In addition, CDP cases are excluded if the taxpayer is not current with filing requirements and deposits, has not submitted financial information, or has not had a conference with a manager. IRM 5.1.9.3.2.2 (Rev. 12-15-2003).

[47] *See* IRS, Publication 3605 *Fast Track Mediation – A Process for Prompt Resolution of Issues* (Rev. 12-2001).

[48] We understand that the following types of cases are excluded as "collection" cases: Collection Due Process, Collection Appeals Program, Trust Fund Recovery Penalty, and Offer in Compromise.

[49] *See* General Appeals, FTM Technical and Procedural Guidelines, 3-4 (Oct. 8, 2003). IRS has adopted a strategy of centralizing processing for simple OICs (from wage earners) to be worked in campuses, while continuing to process complex OICs in the field. *See, e.g.*, General Accounting Office, *IRS Should Evaluate the Changes to Its Offer in Compromise Program*, GAO-02-31 (March 2002).

Excluding cases from mediation simply because IRS procedures require little management involvement does not make sense. The decision to limit managerial involvement on campus cases is presumably based on resource concerns. However, mediation has been demonstrated to reduce the time and costs of resolving cases. Without it, the IRS is likely to expend additional time and costs on the same cases in Appeals or in litigation, potentially eliminating any savings produced by limiting management involvement. Further, unless a manager will decide the case, it is unclear why managerial involvement is a necessary prerequisite to mediation.[50]

The policy of excluding campus cases results in inconsistent treatment of similarly situated taxpayers. For example, although FTM is generally available for OICs worked in the field,[51] it is not available for OICs worked at a campus.[52]

Excluding campus OIC cases from mediation also appears inconsistent with congressional intent. Code § 7123(b) provides that:

> The Secretary shall prescribe procedures under which a taxpayer or the Internal Revenue Service Office of Appeals may request non-binding mediation on any issue unresolved at the conclusion of … unsuccessful attempts to enter into a … compromise under section 7122.

Although mediation is a form of ADR that requires the consent of both parties, IRC § 7123(b) indicates that Congress intended for mediation to be available to taxpayers unsuccessfully attempting to enter into an OIC, regardless of where the IRS processed the offer. In fact, an Appeals OIC-Mediation Working Group recently recommended that certain OIC cases that are processed in the field be eligible for post-Appeals mediation because the existing exclusion of OIC cases from post-Appeals mediation was contrary to IRC § 7123(b).[53]

[50] If the manager is the decision maker, then the manager would be involved in any event.

[51] However, even with respect to OICs worked in the field, FTM is available for only a limited number of issues. FTM is not available for OICs: (1) when the taxpayer has the ability to full pay, (2) when the taxpayer declines to increase the offer amount but does not disagree with IRS numbers, (3) when the issue is covered by procedural guidance, and (4) when rejection is based on public policy. Memorandum from SB/SE Acting Deputy Director, Compliance Policy to SB/SE Acting Deputy Director, Compliance Field Operations, Director, Case Management, regarding Fast Track Mediation for Offers in Compromise (Feb. 27, 2004).

[52] Rev. Proc. 2003-41, *supra*, § 3. In addition, some taxpayers may not be taking advantage of FTM because the information regarding what is eligible and ineligible for FTM are spread out in various documents, including interim guidance, making it difficult for IRS personnel and taxpayers to make the critical determination regarding whether their case is eligible.

[53] Memorandum from Appeals OIC-Working Group to Chief, Appeals, regarding Expansion of the Appeals Mediation Program (May 25, 2004). This group did not recommend extending post-Appeals mediation to campus cases based on the fact that campus cases are excluded from FTM. *Id.*

Appeals may be excluding campus cases based upon the difficulty of obtaining the presence of all parties at the mediation.[54] This is inconsistent with Congress' statements to the effect that geography should not become a barrier to taxpayers utilizing ADR. The IRS Restructuring and Reform Act of 1998 provides that:

> The Commissioner of Internal Revenue shall ensure that an appeals officer is regularly available within each state …[and] consider the use of videoconferencing of appeals conferences between appeals officers and taxpayers seeking appeals in rural or remote areas."[55]

The legislative history of the act further clarifies that "the Committee believes that the ADR process is valuable to the IRS and taxpayers and should be extended to all taxpayers. The Committee believes that all taxpayers should enjoy convenient access to Appeals, regardless of their locality."[56] Therefore, instead of allowing the existing campus organizational structure to limit the IRS' use of successful ADR techniques that Congress intended to be used, the IRS should find a way to use ADR effectively in connection with cases worked in campuses.

IRS Decision Making Authority

An essential element of successful mediation is the inclusion of all decision makers. Unless participants have full authority to resolve a dispute, it will not be resolved. Both post-Appeals mediation and FTM recognize this by requiring the taxpayer participants to include all decision makers.[57] In FTM, however, the authority of IRS participants may be diluted because they do not always have "hazards of litigation" authority for compromise, which may be the reason that cases involving "hazards of litigation" issues are excluded from FTM.[58] If the goal of the program is to promote settlements, it makes no sense to limit the IRS's ability to agree to a reasonable settlement or to exclude issues from resolution through the mediation process. In fact, mediators often help the parties focus on the weaknesses of their cases and evaluate the likely result if the dispute cannot be resolved by mediation. This analysis will sometimes be useless in FTM because even if the IRS agrees that it could

[54] *See* General Appeals, FTM Technical and Procedural Guidelines 3-4 (Oct. 8, 2003).

[55] Pub. L. No. 105-206, § 3465(b)-(c) (1998).

[56] S. Rep. No. 174, 105th Cong., 2nd Sess. 92 (1998).

[57] Rev. Proc. 2002-44, *supra*, § 5.05 (providing that "the parties to the mediation process will be the taxpayer and Appeals. Absent an agreement to the contrary, each party must have at least one participant attending the mediation session with decision-making authority."); Rev. Proc. 2003-41, *supra*, § 5.05 (providing "[a]t least one representative with decision-making authority for each party must be present at the mediation sessions, or be available for consultation, unless the case is an OIC case over $50,000 (including tax, penalty, and interest) for which Counsel approval is currently required pursuant to section 7122(b)"). *See also* Rev. Proc. 2003-41, *supra*, § 6.03.

[58] Rev. Proc. 2003-41, *supra*, § 3.01. "Hazards of litigation" are considered by Appeals in both examination and collection cases and by IRS operating divisions in evaluating offers in compromise based upon "doubt as to liability." *Id*; Rev. Proc. 2003-71, 2003-36 I.R.B. 517 § 4.02. However, the IRS examination division typically does not have authority to settle a case on this basis.

not obtain a better result in Appeals or in court, in some cases it has no authority to accept such a settlement in FTM. The benefits of mediation will not be fully realized unless the process is used and the IRS participants have full authority to resolve the dispute.

Appeals indicates that it plans to resolve this problem by expanding FTS to SB/SE taxpayers, which may partially fill the Fast Track void for SB/SE taxpayers whose cases involve hazards of litigation issues. In FTS the IRS negotiator from Appeals can use his or her authority to settle on the basis of hazards of litigation.[59] We commend Appeals for this decision. Although the FTS procedure is not mediation, this new policy should allow SB/SE taxpayers with hazards of litigation issues to readily participate in a form of ADR while the case is still in compliance's jurisdiction.

Current Mediation Procedures May Reduce Taxpayer Participation

Post-Appeals mediation and FTM are the IRS dispute resolution procedures that most closely resemble typical mediation. However, they differ from typical mediation (including mediation procedures used by the IRS in the few Tax Court mediations that occur) in a few key respects, which may contribute to the low utilization of these programs by taxpayers and reduce their success.

Mediators typically hold joint sessions followed by private caucuses with each of the parties in which they ask negotiators for each side about the reasoning and factual assumptions.[60] For these private caucuses to be useful, the parties must trust the mediator with information that they may be unwilling to disclose to the other side. Confidentiality of information disclosed in the separate caucuses is essential to successful mediation because taxpayers are less likely to provide information to the mediator if they believe that it may reach the other party.[61]

For similar reasons, the mediator will be less effective if he or she is viewed as having a conflict of interest. Even the perception of a conflict is likely to reduce the mediator's effectiveness, because if the mediator is not seen as neutral, the taxpayer is less likely to be fully candid with the mediator, or respond to his or her suggestions or solicitation of ideas.[62]

[59] Interview with Office of Appeals, Technical Services, Director, Tax Policy/Procedure (LMSB/TEGE) (Jun. 9, 2004). Under current procedures an SB/SE taxpayers may in some cases be permitted to participate in FTS, but only upon special request and approval of Appeals' Fast Track Program Managers and a Compliance manager from SB/SE. Rev. Proc. 2003-40, 2003-25 I.R.B. 1044 § 3.02 (Jun. 3, 2003).

[60] *See, e.g.*, Kimberlee K. Kovach, *Mediation Principles and Practice*, 3rd ed., West, 2004, 35-38.

[61] *See, e.g.*, Dwight Golann, *Mediating Legal Disputes, Effective Strategies for Lawyers and Mediators*, § 1.2.4, § 13 (Aspen 1996). Recognizing the importance of confidentiality, the ADR Act, with certain limited exceptions, prohibits disclosure by a neutral of any dispute resolution communications and communications provided in confidence. 5 U.S.C.A. § 574(a) (West 2004).

[62] *See*, at § 1.2.2 (observing that the perception of neutrality protects the mediator from "reactive devaluation," i.e., the tendency to be suspicious of anything proposed by an adversary, and "escalation," *i.e.*, responding to an opponent's concessions with a more inflexible negotiating position, citing Robert H. Mnookin, *Why Negotiations Fail: An Exploration of the Barriers to the Resolution of Conflict*, 8 Ohio St. J. on Disp. Resol., 235 (1993)). On the other hand, an Appeals employee may be more likely to be perceived by the IRS participants as neutral than a non-IRS mediator. Thus, in some cases an IRS mediator may be viewed by the taxpayer as more useful in helping the IRS change its position than a non-IRS mediator.

A mediator who is truly impartial can also be more creative in identifying settlement options, is often able to evaluate the merits of a case more accurately than the participants, and is more likely to be successful.[63]

Conflict of Interest Caused by Utilizing IRS Employees as Mediators

Both FTM and post-Appeals mediation require the use of mediators who are employees of the IRS Appeals organization, but in post-Appeals mediation taxpayers are at least permitted to hire non-IRS co-mediators at their own expense.[64] IRS employee mediators have a conflict of interest by reason of the duty of every IRS employee to report information concerning violations of any revenue law to the Secretary pursuant to IRC § 7214(a)(8). They may also be perceived as having a conflict based on the perception that since Appeals employees generally act as negotiators on behalf of the IRS it will be difficult for them to act as neutral third parties in the mediation.[65] Because of this perception, many taxpayers may simply choose not to participate in FTM at all.

Requiring the use of IRS employees as mediators in the post-Appeals mediation program may also be inconsistent with the intent of Congress. When Congress codified the pilot post-Appeals mediation procedures in 1998, it presumably contemplated that taxpayers would retain the right to select a private sector mediator as the sole mediator (rather than only as a co-mediator) subject to IRS approval, as was the case in the pilot program.[66]

The requirement to use an Appeals employee as a mediator may be a result of the IRS' perception that the cost of hiring a private mediator would dilute the benefit of mediation if IRS paid half of those costs. However, a private mediator may be the sole mediator in the IRS' Tax Court mediation program even though the government pays for half the cost of the mediator in those cases.[67] Since the use of a private sector mediator is not mandated by the Tax Court, IRS' policy suggests that the IRS has determined that such a program is feasible.

[63] *See, e.g.*, Dwight Golann, *Mediating Legal Disputes, Effective Strategies for Lawyers and Mediators*, § 1.2.3 (Aspen 1996). For example, only a mediator believed to be truly neutral can assist the parties with a decision tree analysis in which the mediator helps them break-down and evaluate their assumptions. *Id.* at § 10 and § 11.

[64] In the pilot post-Appeals mediation program, however, taxpayers were free to choose a mediator who was not an IRS employee (from any local or national organization providing a roster of neutrals) and the IRS would share the expense. *See* Announcement 98-99, I.R.B. 1998-46 § 4 (Oct. 30 1998). In post-Appeals mediation, as it stands today, the IRS employee mediator is selected by Appeals and the taxpayer from a list of eligible Appeals personnel who are generally from the same Appeals office or geographic area (but not the same group) where the case is assigned. Rev. Proc. 2002-44, *supra*, § 5.07. In FTM, the Appeals Manager simply assigns an Appeals employee trained in mediation to be the mediator. Rev. Proc. 2003-41, *supra*, § 5.02. The rationale for these different approaches is unclear.

[65] *See* General Accounting Office, *IRS Initiatives to Resolve Disputes Over Tax Liabilities*, GAO/GGD-97-71, 6 (May 9, 1997) (suggesting that Appeals is viewed as a negotiator on behalf of the IRS rather than as a true neutral).

[66] *See* Announcement 98-99, *supra*, §§ 4-7. However, even during the pilot Appeals' decision to mediate could depend on the taxpayer's acceptance of an Appeals mediator. *Id.*

[67] *See* IRM 35.3.20.4 (Rev. 1-24-1996). Although a court could require a private mediator in a given case, Tax Court Rule 124 merely states that "[n]othing contained in this Rule shall be construed to exclude use by the parties of other forms of voluntary disposition of cases, including mediation."

The IRS' current solution to the conflict of interest created by the mediator's employment with the IRS is to have the mediator disclose the conflict to the taxpayer and include the disclosure as part of the mediation agreement.[68] However, this provides no opportunity for a taxpayer to have a meaningful agreement regarding the mediator's conflict, since in most instances the only option for a taxpayer who objects to the conflict is to not use the program. This is at odds with the goal of increasing the use of mediation.

Confidentiality Concerns

A related taxpayer concern may be that the FTM mediator could later be assigned to the case as an Appeals Officer (or Settlement Officer). Although such an assignment would be inconsistent with IRS procedures, we have heard that mediators are sometimes assigned as the Appeals Officer for cases that they have mediated.[69] In such a case, the mediator in his role as an Appeals Officer would have access to all of the confidential communications he received in FTM.

In contrast, non-IRS mediators in post-Appeals mediation are disqualified from representing the taxpayer in any pending or future action that involves the transactions or issues that relate to the subject matter of the mediation.[70] Presumably, this policy is based upon the IRS' legitimate concerns regarding confidentiality and conflicts of interest that might otherwise exist for non-IRS mediators hired to work for the taxpayer in resolving issues not settled through mediation. These are the same conflict of interest concerns that taxpayers may have about IRS mediators who could potentially be assigned to work the same cases for the IRS in Appeals.

In addition, where the mediator becomes the Appeals Officer, IRS compliance would have had the opportunity to communicate directly with the officer regarding the case. Such communications would otherwise be prohibited under the *ex parte* rules governing communications between compliance and Appeals and which foster Appeals' independence.[71] Those rules are expressly suspended in connection with the FTM process.[72] However, the IRS could easily reduce such confidentiality and conflict of interest concerns by enforcing

[68] The FTM agreement is IRS Form 13369, which provides "the parties also acknowledge that IRS and all other Treasury employees involved in the mediation are bound by IRC section 7214(a)(8) and must report information concerning violations of any revenue law to the Secretary." A similar statement is provided to taxpayers engaged in post-Appeals mediation. *See* Rev. Proc. 2002-44, *supra*, § 5.07 (stating: "Due to the inherent conflict that results because the Appeals mediator is an employee of the IRS, the Appeals mediator will provide to the taxpayer a statement confirming his/her proposed service as a mediator, that he/she is a current employee of the IRS, that a conflict results from his/her continued status as an IRS employee, and that this conflict will not interfere in the mediator's ability to impartially facilitate the case.").

[69] *See* General Appeals, FTM Technical and Procedural Guidelines 1 (Oct. 8, 2003) (indicating that if the FTM issues remain unresolved and the case is forwarded to Appeals, it will be assigned to a different Appeals Officer).

[70] Rev. Proc, 2002-44, *supra*, § 5.13.

[71] Rev. Proc. 2000-43, 2000-2 C.B. 404 (Oct. 11, 2000) (limiting *ex parte* communications with Appeals). *Ex parte* communications are communications that take place between Appeals and another IRS function without the participation of the taxpayer or the taxpayer's representative. *Id.*

[72] Rev. Proc. 2003-41, *supra*, § 5.10.

its prohibition on an Appeals Officer being assigned to a case that he mediated (unless requested by the taxpayer), thereby removing a potential taxpayer concern. Alternatively, it could allow non-IRS mediators who do not have conflicts of interest.

Taxpayers may be concerned that if agreement cannot be reached in FTM, then the information disclosed to the IRS mediator may reach the Appeals Officer who is later assigned to the case. Disclosure by the mediator would violate the ADRA.[73] Additionally, FTM procedures are "confidential" by their terms.[74] However, IRS procedures could be clearer in expressly barring the disclosure of information obtained from the mediation to an Appeals Officer should the issue proceed to Appeals. To alleviate these concerns, the IRS should adopt policies and standard FTM agreements that specifically broaden the mediator's duty to refrain from disclosing information received in mediation to anyone, expressly including other employees of the IRS (except as required by law or by a court), and the mediator should reiterate that policy at the beginning of the mediation session.[75] These simple changes could ease taxpayer concerns and increase the effectiveness and use of the FTM program. Because the same confidentiality issues may exist with respect to communication between a post-Appeals mediator and IRS Counsel in the event that the case proceeds to litigation, similar confidentiality policies should be adopted for post-Appeals mediators.

Another possibility for addressing conflict of interest and confidentiality concerns would be for Appeals to permit the use of qualified non-IRS mediators (without an IRS co-mediator) in FTM and in post-Appeals mediation upon request. If such a policy were adopted and effectively communicated to private sector mediation groups, private mediators could help educate taxpayers and practitioners about IRS mediation programs.

Current IRS procedures provide that non-IRS co-mediators may be used in post-Appeals mediation, provided they are members of any national or local mediator's organization.[76] According to Appeals, the taxpayer is not required to choose co-mediators from a pre-

[73] 5 U.S.C.A. § 574(a) (West 2004). However, FTM and post-Appeals mediation also require that the IRS mediator to provide a copy of any "submission" that he or she receives to the other party. Rev. Proc. 2003-41, *supra*; Rev. Proc. 2002-44, *supra*. Since the ADRA's confidentiality rules applicable to a "party" (rather than the mediator) do not protect dispute resolution communications that are available to all parties, disclosure by the IRS participants of "submissions" made to the mediator (and distributed to the other parties) may not be fully protected under the ADRA. 5 U.S.C.A § 574(b)(7) (West 2004).

[74] Rev. Proc. 2003-41, *supra*, § 5.08. Post-Appeals mediation is also "confidential." Rev. Proc. 2002-44, *supra*, § 5.10.

[75] Given the lack of consequences that result from the IRS's violation of its *ex parte* rules, the use of specific confidentiality clauses in the mediation agreement may be particularly important to improve the credibility of the IRS' confidentiality policy even if such a clause may be difficult to enforce. *See Robert v. US*, 364 F.3d 988 (8th Cir. 2004) (holding that *ex parte* communications between IRS Appeals Office and Examination Division regarding substance of taxpayer's appeal violated the law but that no remedy was provided for such violations). The Federal Alternative Dispute Resolution Council also recommends that the mediator make a statement at the beginning of the mediation clarifying the confidentiality rules. *See* Federal Alternative Dispute Resolution Council, Confidentiality in Federal Alternative Dispute Resolution Programs, 65 Fed. Reg. 83,085 (Dec. 29, 2000).

[76] Rev. Proc 2002-44, *supra*, § 5.08 (explaining that "if the taxpayer elects to use a non-Internal Revenue Service co-mediator, the taxpayer and the Appeals Team Manager should make the selection from any local or national organization that provides a roster of neutrals.").

approved list of neutrals.[77] However, this may not be widely known by private mediators. Therefore, even if the IRS does not expand its use of private mediators it should increase its education and outreach to them so that they can assist in publicizing the IRS post-Appeals mediation program.

IRS Mediator Training

Continuing education is essential for mediators to maximize their effectiveness. In recognition of this, several courts and states have continuing education requirements for mediators.[78] IRS mediators do not regularly receive any such continuing education.[79] Another way that mediators can maintain their skills is by frequent mediation experience. However, while 430 Appeals employees are trained as mediators, in FY 2004 there were only 112 FTM case closures and 26 post-Appeals mediation case closures.[80] On average this is less than one closure per mediator per year, suggesting that IRS mediators are not gaining significant experience.

IRS COMMENTS

Appeals Alternative Dispute Resolution (ADR) Processes

Appeals serves as the administrative forum for any taxpayer contesting an IRS compliance action, offering taxpayers both traditional case resolution authority or the ADR techniques that Appeals has developed. It is important to also include the Appeals Technical Guidance programs involving early decision on large projects and abusive schemes, as an effective ADR case resolution strategy. When all of these methods are combined with Appeals' traditional settlement role, we believe that the IRS has a very strong presence in alternative dispute resolution.

Taxpayer Utilization of IRS Mediation Programs

From its inception, the guiding principle behind the post-Appeals mediation program is that it should neither interfere with nor replace the established Appeals administrative process. This guiding principle remains in place today.

[77] Interview with Office of Appeals, Technical Services, Director, Tax Policy/Procedure (LMSB/TEGE) (Jun. 9, 2004).

[78] *See, e.g.*, U.S. Dist Ct. Rules, S.D. Tex. Rul. LR16.4E (3)(d) (2000) (requiring 5 hours of training per year); LSA-R.S. 9:4106 (West 2004) (requiring 10 hours of training every two years).

[79] E-mail response to TAS Information Request by Appeals, Director, Tax Policy and Procedure (SBSE and W&I) (Oct. 26, 2004) (indicating that no continuing education is required for IRS mediators but that they may apply for it).

[80] E-mail response to TAS Information Request by Director, Technical Services, Appeals (Jul. 19, 2004); E-mail response to TAS Information Request by Appeals, Director, Tax Policy and Procedure (SBSE and W&I) (Oct. 26, 2004) (indicating 112 FTM disposals); E-mail response to TAS Information Request by Appeals, Director, Tax Policy and Procedure (LMSB/TEGE) (Nov. 2, 2004) (indicating that the 26 post-Appeals case closures in FY 2004 included: 10 agreed; 3 unagreed; 3 denied; 3 withdrawn; 1 returned to Compliance; and 6 closed without mediation).

Appeals mediation programs are conducted at the pre and post-Appeals stages. Fast Track Mediation (FTM) is designed to help Small Business/Self Employed taxpayers resolve many disputes resulting from examinations (audits), offers in compromise, trust fund recovery penalties, and other collection actions. During Fiscal Year 2004, there were 134 FTM receipts and 112 closures. Of the 112 cases closed, 59 percent were closed with an agreed resolution. The use of FTM decreased cycle time for taxpayers by 206 days for examination and collection work combined, and by 291 days for examination work. As taxpayers learn about how FTM can expedite their SB/SE case resolution, more of them will consider using it. In addition, while the Fast Track Settlement (FTS) process was not included in the initial release of the Fast Track Mediation program, Appeals and SB/SE have recommended its expansion to include a FTS procedure for SB/SE. A revenue procedure is currently in the clearance process and awaiting approval for publication. Until then, Appeals is accepting SB/SE cases for FTS on a project or case-by-case basis. The addition of settlement authority to the SB/SE work streams should increase taxpayer interest in the ADR process.

Sources of cases for the post-Appeals mediation program are generally from the Coordinated Industry, Industry and Examination workstreams and Appeals reaches settlement with taxpayers on about 85 percent of them. Since 1995, there were 146 requests for post-Appeals mediation, including 24 in Fiscal Year 2004. While the number of ADR cases is not voluminous, it did involve approximately $14 billion in disputed adjustments.

An important consideration is that post-Appeals mediation is an optional program that occurs after settlement negotiations take place. As such, it is considered to be “another tool in the toolbox” to accomplish our mission. An important development in the program is that a number of cases resolved after a mediation request was made, but before the case proceeded to a mediation session. In fact, during the negotiation of the mediation agreement, parties often developed options to resolve the case. Appeals representatives make an effort to emphasize this aspect of the post-Appeals mediation program at meetings with tax practitioners.

Communication is the key to fostering the use of the ADR programs. Appeals will continue to solicit both taxpayer and Compliance interest in these programs. The FTS program has been successful in the Large and Mid-Size Business (LMSB) Operating Division because taxpayers have tried the program, experienced success and spread the news to other tax practitioners that it helped to resolve their case. Over 20 percent of the large case disposals in Fiscal Year 2004 were FTS. Most important is the fact that out of 480 new case assignments, 122 were FTS cases.

Education and Publicity

We agree with the National Taxpayer Advocate that education and publicity for all stakeholders is fundamental to the success of any ADR program. The IRS believes that this is vital to the expansion of the ADR programs. The National Taxpayer Advocate says that the IRS has not fully evaluated the effectiveness of its efforts; the IRS believes there are sufficient measures in place to evaluate them.

Many of the presentations made to practitioners, such as the nationwide tax forums, include a measurement component. In addition, Appeals has a distinguished history of publishing IRS Announcements with new ADR procedures for a test period, so that they can be evaluated before and during implementation. Through this innovation, Appeals publishes the final revenue procedure at the end of a validation process, rather than at the beginning. Additionally, internal and external customer satisfaction surveys are given to participants in ADR programs to provide feedback to Appeals. Finally, Appeals expects to finalize performance measures for its mediation programs in FY 2005.

Appeals and SB/SE monitor the effectiveness of the FTM program on a monthly basis and conducted site visitations at the Atlanta and Philadelphia Appeals offices. SB/SE subsequently issued a memorandum in May 2004 to all SB/SE field examiners, "Guidance to the Field on the Effective Use of Fast Track Mediation for Unagreed Examination Cases." For the evaluation of Fast Track Settlements, Rev. Proc. 2004-40 established the position of the FTS Program Manager in both Appeals and LMSB to monitor and facilitate acceptance of Applications for Fast Track Settlement.

Exclusions from IRS Mediation

As a matter of sound policy for tax administration, Appeals exercised its authority to apply reasonable restrictions on the availability of mediation and excluded collection cases. Furthermore, Appeals developed the mediation procedures with the review and concurrence of the Office of Chief Counsel, the Commissioner of Internal Revenue and the Assistant Secretary of Treasury for Tax Policy. Appeals is constantly considering the expansion of its ADR programs, and we are in the process of finalizing procedures to allow for post-Appeals mediation of Offers in Compromise (OIC) cases. Until then, Appeals is accepting OIC cases for mediation on a case-by-case basis.

The Collection Appeals Program (CAP) is the ADR process for most collection cases and has a five-day turn-around goal to resolve them. Although CAP is not an ADR process since we do not utilize a neutral third party, it gives the taxpayers an alternative to traditional Appeals. Regarding the Automated Collection System cases, Appeals believes that the timeframes for formally requesting an administrative appeal are such that ADR would not be practical for them. Field collection cases may have some ADR application, and Appeals will continue to explore resolution opportunities with SB/SE.

For the FTM program, the IRS established a design team with a cross-functional group of six Small Business/Self Employed and Appeals specialists. The team conducted a thorough review of the relevant factors for inclusion in, or exclusion from, the program. A consensus opinion for the current eligibility standards was reached, based in part on the results captured from the pilot program, feedback obtained from managers and examiners in the field, and the experience of the team members. The team established the initial eligibility requirements, intending to revisit them for future expansion.

We note the reference by the National Taxpayer Advocate to the Appeals videoconferencing alternative for hearings with taxpayers in remote areas, which was included in the IRS Restructuring & Reform Act of 1998. From October 1999 – March 2000, the U. S. Court of Appeals for the Tenth Circuit in Denver, CO, and the U. S. Bankruptcy Courts located in Cheyenne and Casper, WY, allowed IRS Appeals to use the videoconferencing system of the courts to conduct Appeals hearings with taxpayers. Despite Appeals best efforts to publicize the availability of videoconferencing for Appeals hearings, all of the Wyoming taxpayers declined to participate in the test. While videoconferencing does not appear to be a viable option for conducting Appeals hearings, it may be beneficial for certain types of mediation cases, such as campus disputes, and Appeals will consider testing it.

Appeals and SB/SE will continue to explore ways to expand ADR techniques within campus operations. For example, the FTM program now includes Electronic Fund Transfer Deposit penalty cases within campus operations. In addition, Appeals initiated four Payroll Provider cases from campus sites in situations where each payroll provider represented one hundred or more taxpayers; these cases were resolved successfully. Discussions are underway to use FTS for these types of cases. The FTM program was also expanded to include tax-exempt bond cases on a pilot basis. Appeals and TE/GE agreed to expand the FTM program to include Credit Counseling cases.

IRS Decision Making Authority

We agree with the National Taxpayer Advocate that an essential element for successful mediation is the inclusion of all decision makers. In the ADR programs, the Appeals or Settlement Officer may have different roles, including being a mediator, a decision maker, or a combination of both. Each ADR technique is specifically designed for a particular purpose. We do not agree that all ADR techniques must include applying "hazards of litigation" authorities. FTM does not provide for Appeals settlement authority; yet it may be the most appropriate technique for fact-based cases. Having the ability to elect FTM or FTS is an excellent choice to offer taxpayers.

Due to the complexity and legal restrictions attached to the use of "hazards of litigation" at the front-line level, the FTS process was not included in the initial release of the Fast

Track Mediation program in SB/SE. Appeals and SB/SE continued to weigh the merits of this process and have now recommended the expansion of FTM to include an FTS procedure for SB/SE. A revenue procedure is currently in the clearance process and awaiting approval for publication.

Conflict of Interest Caused by Utilizing IRS Employees as Mediators

Regarding the use of IRS employees as mediators, we note that the Administrative Dispute Resolution Act of 1996 provides that a neutral may be a permanent or temporary officer or employee of the federal government or any other individual who is acceptable to the parties to a dispute resolution proceeding. In complex tax cases, it is an advantage to have co-mediators. During the post-Appeals mediation test periods, a variety of mediator options were used, including a single non-IRS mediator, Appeals mediators, and non-IRS and Appeals co-mediators. Those cases with Appeals and non-IRS co-mediators were very effective for the most complex Coordinated Industry cases.

Inherent in the post-Appeals mediation procedure is the ability for a party to reject a mediator based on a conflict of interest. We note that the election by the taxpayer to use a non-IRS co-mediator at the taxpayer's expense was first proposed by a tax practitioner at the February 1995 mediation public hearing. Taking budget and other considerations into account, since Appeals is assuming the costs of the Appeals co-mediator, it is a reasonable administrative practice for the taxpayer to assume the costs of the non-IRS co-mediator. The mediation procedure also includes mediator conflict safeguards, including a conflict statement to be provided by the mediator.

The major advantage of using an Appeals mediator is their technical knowledge and expertise in tax law. This factor was addressed by the FTM design team prior to implementation of the program. During the policy formulation stage, a suggestion was received to include Equal Employment Opportunity mediators, from inside and outside of the IRS, in the FTM program. In reviewing this suggestion, the team referred to the FTM pilot results which revealed that one of the key components of a successful (agreed outcome) mediation session was the mediator's technical and legal credentials. The high ratio of agreed outcomes to total FTM sessions appears to support the team's conclusion that the value of the technical and legal expertise of trained IRS Appeals mediators outweighs any conflict of interest or confidentiality concerns. In our experience administering the mediation programs, the mediator conflict of interest provisions are not controversial.

Confidentiality Concerns

In FTM, an Appeals manager assigns the case to an Appeals Official trained in mediation. If the taxpayer and the Compliance officer do not reach agreement and the taxpayer requests that the case be forwarded to Appeals, a different Appeals officer will be assigned the case. In some cases, a taxpayer may request that the Appeals mediator for the FTM be assigned the case in Appeals. While Appeals would consider the taxpayer's request, we would not make such a case assignment on our own initiative. We believe that the mediation procedures contain essential confidentiality protections by referencing the expectations set forth in the Administrative Dispute Resolution Act of 1996. In addition, Appeals and Settlement Officers are subject to confidentiality and disclosure of returns and return information rules under section 6103 of the Internal Revenue Code. Further, any records or documentation received by the Appeals mediator are destroyed by shredding at the conclusion of the mediation sessions.

We agree with the National Taxpayer Advocate that a dispute resolution communication made available to the other party, such as a mediation submission distributed by a party to the other party in a joint session, would not be protected from disclosure. However, we note that the parties may agree upon alternative confidential procedures in writing, for disclosures by a neutral. Presumably, the parties could also sign the alternative confidential procedures. To date, we are not aware that any parties to post-Appeals mediations have expressed the need to enter into an alternative confidentiality agreement. Appeals will consider making available to mediators draft confidentiality statements to use if the need arises, and additional confidentiality information highlighting the disclosure requirements.

IRS Mediator Training

Over four hundred Appeals and Settlement Officers are trained as mediators. We agree that continuing education is essential for full-time mediators to maximize their effectiveness; however, we do not agree with the conclusion that IRS mediators are not gaining significant experience.

One of the basic techniques in mediation training is that of negotiation. The most creative aspect of negotiation consists of the development of options that enable both sides to a dispute to resolve issues. Our employees are in fact maintaining the skills they learned through mediation training through their daily interaction with taxpayers and representatives. Appeals is developing an Appeals Mediator Continuing Professional Education program for future implementation.

TAXPAYER ADVOCATE SERVICE COMMENTS

The IRS should be commended for:

- *Using mediation procedures to significantly reduce processing times as compared to regular IRS processes,*
- *Testing mediation procedures so that they could be improved before being finalized,*
- *Expanding the Fast Track Mediation (FTM) program to campus Electronic Fund Transfer Deposit penalty cases, campus Payroll Provider cases, Tax Exempt Bond cases and Credit Counseling cases,*

- *Developing procedures to expand post-Appeals mediation to Offer in Compromise cases;*
- *Developing procedures to make the Fast Track Settlement process more readily available to SB/SE taxpayers;*
- *Considering making form statements available to mediators to use to highlight the communications that will be confidential and that are required to be disclosed;*
- *Developing a Continuing Professional Education program for Appeals mediators; and*
- *Developing performance measures for IRS mediation programs.*

The fact remains, however, that while the IRS' FTM and post-Appeals mediation programs have great potential to save time and money and improve case outcomes and customer satisfaction, they are rarely used. The National Taxpayer Advocate proposes the following to address this problem and to improve the programs:

- *The IRS should survey eligible taxpayers who did not use the IRS mediation programs to determine why they did not use them (e.g., do they know about them? Do they know they are eligible for them? Are they intimidated by foreign procedures? Do they have confidentiality concerns? Do they think the mediation process will not work, and if not, why?).*
- *The IRS should continue its outreach and education efforts to expand the use of its mediation programs. The IRS should measure the relative effectiveness of various types of outreach and education so that its efforts are focused most efficiently.*
- *The IRS should revise its quality review process to measure whether IRS employees offer FTM and post-Appeals mediation to eligible taxpayers.*[81]
- *The IRS should **not** exclude any cases or issues from mediation programs without a clear written justification for why mediation would not resolve the dispute more quickly and cost effectively than the alternatives. This justification should then be reevaluated when circumstances change. If processing cases in a centralized location is a barrier to the availability of mediation in cases where mediation would be effective, the IRS should reconsider whether such cases should be processed in a centralized location. Appeals' proposal to consider testing mediation via videoconferencing may be one way of addressing this problem, provided the use of videoconferencing does not dilute the effectiveness of mediation.*[82] *In connection with any such test, IRS should evaluate whether mediation effectiveness is impaired by the lack of a physical presence.*
- *When the IRS expands the availability of its mediation programs (such as to certain campus cases, discussed above), such changes should be widely publicized and incorporated into existing published guidance. Appeals should regularly publish updated guidance that clearly*

[81] TAS faces a similar challenge in getting other parts of the IRS to make referrals to TAS, as discussed in the Most Serious Problem entitled *Access to the Taxpayer Advocate Service, infra*.

[82] Appeals should not be discouraged by the fact that few Wyoming taxpayers chose to use videoconferencing for Appeals hearings in its test five years ago. New technologies take time to gain acceptance. For example, few taxpayers even had cell phones five years ago. Appeals should test videoconferencing again, and if it is not used, Appeals should survey those who did not use it to find out why.

identifies (in a single publication) the cases and issues that are eligible and ineligible for its various mediation programs.

- *Appeals' informal practice of allowing taxpayers to request that an Appeals mediator be assigned to hear an appeal involving issues not resolved through FTM should be incorporated into its published guidance. This guidance should also make clear that an Appeals mediator in FTM will not be assigned to the case when it reaches Appeals except upon the taxpayer's request. In cases where insufficient settlement authority is the only barrier to compromise, the Appeals mediator could quickly resolve such issues in his or her role as an Appeals Officer or Settlement Officer.*[83]
- *The IRS should allow the use of qualified private sector mediators as either sole mediators or as co-mediators in both FTM and post-Appeals mediation, upon request.*[84] *While Appeals mediators generally have valuable technical and legal expertise, an increasing number of qualified private sector mediators are available who have similarly valuable expertise and have more extensive mediation training and experience (e.g., former Tax Court judges). The use of qualified private sector mediators may alleviate conflict of interest and confidentiality concerns, and create additional incentives for private sector mediators to promote and educate taxpayers and practitioners about IRS' mediation programs.*
- *The IRS should revise its form mediation agreements to clarify that oral statements to the mediator outside of a joint session will not be disclosed to the other parties and will be kept confidential by the mediator. These confidentiality rules should be reiterated at the start of each mediation session. Otherwise, unstated confidentiality concerns may either deter taxpayers from using IRS mediation programs or reduce the effectiveness of the programs.*
- *Appeals should only allow the use of mediators who have received continuing mediation training or have obtained a significant amount of recent mediation experience. Appeals should rapidly implement the continuing education program that it is developing so that Appeals mediators can satisfy such requirements. An Appeals Officer's negotiation experience is no substitute for mediation experience or training. Nearly every attorney engages in regular negotiations; however, nobody could reasonably suggest that nearly every attorney is automatically qualified to be mediators based solely on negotiation experience. IRS mediators, like other mediators, need continuing education in mediation or frequent mediation experience to maximize their effectiveness.*

[83] Expansion of the Fast Track Settlement process to SB/SE taxpayers should provide another avenue to resolve cases involving "hazards of litigation".

[84] To make the use of private sector mediators more feasible in all appropriate cases, the IRS should share the cost of these private sector mediators as they did under the pilot post-Appeals mediation program and as it does under Tax Court mediation procedures. The United States Post Office (USPS), in its workplace mediation program, pays all mediator fees. In an effort to recoup some of its costs, USPS requires each participating private sector mediator do one case *pro bono*. *See* Lisa B. Bingham, *Mediation at Work: Transforming Workplace Conflict at the United States Postal Service*, Oct. 2003, 16 (available at http://www.businessofgovernment.org/pdfs/Bingham_Report.pdf).

PROBLEM

TOPIC E-19 MOST SERIOUS PROBLEM: OFFERS IN COMPROMISE

DID YOU KNOW?

- The number of Offer in Compromise (OICs) returned to taxpayers increased from 43,936 (or 39 percent) in FY 2001 (prior to centralization in IRS campuses) to 70,911 (or 57 percent) in FY 2004 (after centralization).[1]
- Although the percentage of OICs "disposed of" within the IRS' six-month goal has increased from 32 percent in FY 2001 (prior to centralization) to 55 percent in FY 2004, the average OIC processing time increased from 310 days in FY 2001 to 380 days in FY 2003.[2] (No comparable data is available for FY 2004).
- The number of OICs accepted declined from 38,643 (or 34 percent) in FY 2001 to 19,546 (or 16 percent) in FY 2004, while the number rejected increased from 13,976 (or 12 percent) in FY 2001 to 25, 654 (or 21 percent) in FY 2004.[3]
- A recent IRS study found that:[4]
  - Approximately 30 percent of the OICs received by the IRS were previously returned to the taxpayer.
  - When returned OICs were resubmitted, 24 percent were ultimately accepted, 55 percent were returned again and dropped out of the system, 12 percent were rejected, and 10 percent were withdrawn.
  - About 80 percent of the taxpayers with accepted OICs remained substantially compliant during the following five years.
  - Twenty percent of the individual tax accounts and 45 percent of the business tax accounts associated with rejected or withdrawn OICs were classified as "currently not collectible."
  - The IRS eventually collected less than 80 percent of what individual taxpayers were offering in 54 percent of the OICs that it rejected and in 66 percent of the OICs that it returned after acceptance for processing.
  - The IRS eventually collected less than half of what individual taxpayers were offering in 44 percent of the OICs that it rejected, and in 59 percent of the OICs that it returned after acceptance for processing.
  - The IRS collected nothing from individual taxpayers in 21 percent of the OICs that it rejected and in 37 percent of the OICs that it returned after acceptance for processing. The IRS collected nothing from business taxpayers in 46 percent of the OICs that it rejected and in 60 percent of the OICs that it returned after acceptance for processing.

---

[1] SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2001 and FY 2004.

[2] *Id;* SB/SE Performance Measurement, Collection Quality Measurement System (CQMS) Database, Closed Date Compressed Report – National Results, FY 2001 and FY 2003.

[3] SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2001 and FY 2004.

[4] SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program,* Sept. 2004. The collectibility results, discussed below, included cases closed in 1998 and collections through Sept. 8, 2003. *Id.*

RESPONSIBLE OFFICIALS

Kevin M. Brown, Commissioner, Small Business/Self Employed Operating Division
David B. Robison, Chief, Appeals

DEFINITION OF PROBLEM

The Internal Revenue Service's (IRS') "offer in compromise" (OIC) program allows for the compromise of tax liabilities based upon "doubt as to liability" or "doubt as to collectibility," or in furtherance of "effective tax administration."[5] The IRS' goal for the OIC program is to achieve collection of what is reasonably collectible at the least cost and at the earliest possible time, and to promote future compliance by providing taxpayers with a "fresh start."[6] OICs also promote future compliance by requiring, as a condition of the OIC agreement, that the taxpayer file returns and pay taxes for the following five years.[7] In 1998, Congress expanded the bases for compromise to include "effective tax administration," based on its belief that OICs promote voluntary compliance.[8] The intended effect of this expansion was generally to increase the IRS' flexibility in accepting OICs. The conference report for this legislation explained:

> The conferees believe that the IRS should be flexible in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.[9]

Notwithstanding this legislative history, IRS policies and practices adopted since 1998 in many cases do not enable the IRS to be flexible or make it easy for taxpayers to enter into OICs. To the contrary, IRS practices and policies continue to make it very difficult for taxpayers to enter into OICs. Moreover, a recent IRS study suggests that in a majority of cases when an OIC is rejected or returned to the taxpayer, the IRS eventually collects *less than the amount that was offered*.[10]

5 *See* Treas. Reg. § 301.7122-1, et. seq.; Form 656, Offer in Compromise (Rev. 7-2004).

6 Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. 1-30-1992).

7 Form 656, Offer in Compromise (Rev. 7-2004). A recent IRS study found that about 80 percent of taxpayers in its sample with accepted OICs remained substantially compliant during the requisite period. SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, 6, September 2004.

8 IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998) (stating that "[t]he Senate amendment provides that the IRS will adopt a liberal acceptance policy for offers-in-compromise to provide an incentive for taxpayers to continue to file tax returns and continue to pay their taxes…. The conferees believe that the ability to compromise tax liability … enhances taxpayer compliance.")

9 *Id.*

10 *See* SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, 11 (Sept. 2004).

The IRS is increasingly returning or rejecting OICs received from taxpayers.[11] Unnecessary OIC returns and rejections are inconsistent with OIC program goals of providing taxpayers with a legitimate alternative method of resolving their tax liabilities (i.e, an alternative to the use of "protracted installment agreements" or classification as "currently not collectible")[12] and a fresh start toward maintaining future compliance, as well as the IRS' overall goal of "improving customer service."[13] Further, the high rate of OIC returns and rejections has not been shown to be cost effective because, in many cases, returned OICs will be submitted again for processing, and many rejected OICs will be processed again by the IRS' Appeals function.[14]

The National Taxpayer Advocate believes that the increase in OIC returns and rejections reflect IRS' use of inflexible policies and automated processes to reduce OIC inventory without regard to how they affect individual taxpayers or whether they actually achieve their goals. We discuss various aspects of these concerns below.

ANALYSIS OF PROBLEM

Background

In August 2001, faced with an increasing number of OICs and rising processing delays, the IRS adopted an OIC inventory reduction strategy.[15] This involved centralizing OIC processing for simple offers (from wage earners) to be worked in the Brookhaven and Memphis campuses (previously called service centers), while still processing complex offers in the field.[16] Today, approximately 66 percent of all OICs are fully processed in the campuses rather than the field.[17]

The inventory reduction strategy also led the Small Business / Self Employed Operating Division (SB/SE), on August 29, 2001, to reduce the number of attempts it would make

[11] SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2001 through FY 2004.

[12] A "protracted installment agreement" is currently defined as an installment agreement extending beyond the statutory period of limitations for collection plus five years. IRM 5.8.1.1.3(1) (Rev. 11-15-2004). An account classified as "currently not collectible" will not be subject to immediate collection action, but the liability will remain outstanding. *See generally* IRM 5.16 (Rev. 1-01-2004).

[13] Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. 1-30-1992) (describing OIC policy); Form 656, Offer in Compromise 1 (Rev. 7-2004) (same); IRS Strategic Plan 2005-2009, Publication 3744 (Rev. 6-2004), 12 (identifying "customer service" as a goal); SB/SE Strategic Plan FY 2004-2005 (Rev. 3-31-2004), 8 (discussing SB/SE's goal of providing "top-quality service to each taxpayer in every interaction").

[14] SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program, 3* (Sept. 2003).

[15] *See* Treasury Inspector General for Tax Administration, *Continued Progress Is Needed to Improve the Centralized Offer in Compromise Program*, Reference 2003-30-182, 1-3 (Sept. 2003) (discussing the increase in offers beginning in 1998, and the IRS' adoption of batch processing techniques); General Accounting Office, IRS Should Evaluate the Changes to Its Offer in Compromise Program, GAO-02-311 (March 15, 2002).

[16] *See* General Accounting Office, *IRS Should Evaluate the Changes to Its Offer in Compromise Program*, GAO-02-311 (March 15, 2002).

[17] SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2004. All offers are initially screened at the campuses to determine processability, but then some are transferred to the field. *Id*; IRM 5.8.2.2(3) (Rev. 11-15-2004).

to obtain information before returning an OIC from "at least two" to one.[18] After an OIC has been accepted for processing, a single communication attempt by phone, in person, or by letter remains the only prerequisite for returning an OIC on the basis of the taxpayer's failure to provide information.[19]

In an effort to offset the cost of processing offers that are ultimately rejected or returned and deter the submission of frivolous OICs, the IRS imposed a user fee on OIC submissions.[20] Since November 1, 2003, the IRS has required taxpayers submitting offers, except those based solely on doubt as to liability, to include a $150 user fee or a low income fee waiver form with their OICs.[21] Offers received without the fee (or the form) are returned as "not processable."[22] Although the fee may be deterring OIC submissions, it is unclear which submissions are being deterred or whether other OICs are being processed more quickly. We do know, however, that the fee increases the cost to taxpayers when OICs are returned or rejected, regardless of the reason for the return or rejection.

COIC Efficiency with Substantive OIC Processing Not Documented

Centralized offer in compromise (COIC) processing has reduced OIC "cycle times"[23] and inventory backlogs[24] by returning more offers to taxpayers rather than by accepting and rejecting more offers.[25] The volume of OICs returned as either "not processable" or after acceptance for processing has increased from 39 percent in FY 2001 to 57 percent in FY 2004, as shown in Table 1.19.1, OIC Dispositions, Fiscal Year Comparison. As a result, IRS has been evaluating the substance of **fewer** offers since centralized OIC processing was adopted.[26]

[18] Memorandum from Deputy Director, Compliance Policy, regarding Return Criteria for Offers in Compromise (Aug. 29, 2001).

[19] IRM 5.8.7.2.2.2 (Rev. 11-15-2004).

[20] T.D. 9086, 68 Fed. Reg. 48,785 (Aug. 15, 2003); Treas. Reg. § 300.3.

[21] *Id.*

[22] Rev. Proc. 2003-71, 2003-36 I.R.B. 517 § 5.01; Form 656, *Offer in Compromise* (Rev. 7-2004) 2. Procedures for returning a "not processable" offer do not always include contacting the taxpayer before the OIC is returned. See IRM 5.8.3 (Rev. 11-15-2004).

[23] SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2001 and FY 2004 (reflecting cycle time improvement). "Cycle time" generally refers to OIC processing time, *i.e.*, the period between IRS' determination that an OIC is processable and disposition of the OIC.

[24] Since centralization was adopted in 2001, the ending inventory has been reduced each year, from 94,931 in FY 2001 to 47,113 in FY 2004. SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2001 through FY 2004.

[25] *See* Treasury Inspector General for Tax Administration, *Continued Progress Is Needed to Improve the Centralized Offer in Compromise Program*, Reference 2003-30-182 (September 2003).

[26] 52,619 OICs (or 46 percent) were accepted or rejected in FY 2001 as compared to 45,200 (or 36 percent) in FY 2004, as shown on Table 1.19.1, OIC Dispositions, Fiscal Year Comparison.

TABLE 1.19.1, OIC DISPOSITIONS, FISCAL YEAR COMPARISON[27]

OIC Disposition	FY 2001		FY 2002		FY 2003		FY 2004	
Returned Not Processable	16,185	14%	32,897	23%	30,406	22%	38,553	31%
Returned Processable	27,751	25%	50,492	35%	49,079	36%	32,358	26%
Accepted	38,643	34%	29,140	20%	21,570	16%	19,546	16%
Rejected	13,976	12%	16,952	12%	27,336	20%	25,654	21%
Withdrawn or Terminated	16,654	15%	13,621	10%	8,431	6%	7,859	6%
Total	113,209	100%	143,102	100%	136,822	100%	123,970	100%

As the IRS has been substantively evaluating fewer OICs, the percentage of OICs disposed of within the IRS' six-month goal has increased from 32 percent in FY 2001 (prior to centralization) to 55 percent in FY 2004,[28] but the *average* time to process an OIC has also *increased* from 310 days in FY 2001 to 380 days in FY 2003.[29] (The IRS has no comparable data for FY 2004). While statistics showing cycle time improvements may reflect actual improvements, they could instead be explained by the fact that OIC returns (after acceptance for processing), which occur at the beginning of the OIC evaluation process, are counted as dispositions.[30] The IRS' focus on the aggregate number of "dispositions" or OICs "processed" over a given period is misplaced because such statistics show improvement as OIC *returns* increase.[31] The IRS does not track whether COIC processing is actually more efficient at substantive OIC processing.[32] Thus, IRS data suggest that COIC processing may be efficient only at quickly returning OICs and may not be more efficient than IRS field offices at substantively evaluating them to reach acceptance or rejection decisions.

[27] *Id.* These numbers include dispositions by Appeals as well as Compliance because IRS statistics do not breakout "rejections" by Compliance. E-mail from Director, Appeals Tax Policy and Procedures (SBSE and W&I) (Jul. 6, 2004). However, since only rejections by Compliance are appealed, if Compliance numbers were reported separately, the number of acceptances would be lower and the number of rejections would be higher.

[28] SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2001 to FY 2004.

[29] SB/SE Performance Measurement, Collection Quality Measurement System (CQMS) Database, Closed Date Compressed Report – National Results, FY 2001 and FY 2003. Of course, cycle times could be affected by shifts in IRS personnel. For example, some OIC specialists have been reassigned to traditional field collection assignments. *SB/SE Strategy and Program Plan*, FY 2004-FY 2005 (Rev. 9-25-2003) 30, 34. IRS should determine which offers are taking longer under existing procedures and take appropriate steps to address such delays.

[30] SB/SE Performance Measurement, Collection Quality Measurement System (CQMS) Database, Closed Date Compressed Report – National Results (definitions).

[31] The aggregate number of OIC "dispositions" that occur in less than 6 months are reported to the IRS Oversight Board. In addition, one IRS Performance Plan measure is the number of OICs "processed" during the period. IRS, *Fiscal Year 2004 Annual Performance Plan* (Feb. 3, 2003), A-4. Focusing on this aggregate cycle time data may communicate the message that IRS views OIC returns as a positive result rather than as a failure to educate taxpayers and work with them as Congress intended. See H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 289 (1998).

[32] E-mail response to TAS Information Request from SB/SE (Nov. 10, 2004).

OIC Returns Lengthen Real "Cycle Times" and Waste Resources

IRS cycle time statistics are also understated because a recent study found that about 30 percent of all OIC receipts were previously returned.[33] Taxpayers, on average, wait for the IRS' acceptance or rejection decision longer than reflected in cycle time statistics because many of them resubmit OICs after they are returned.[34] Therefore, the IRS could reduce its OIC receipts, as well as the actual time it takes to process them, by reducing OIC returns. Further, in many cases even the taxpayer's costs to resubmit a returned OIC will ultimately be borne by the government because those costs (as well as others incurred before the OIC is accepted) will reduce the amount available to be paid to the government. A true measure of cycle time would break out cycle time by type of disposition (e.g., return, acceptance, rejection, withdrawal or termination). It would also measure the time the IRS and taxpayers waste when the OIC is returned and then resubmitted.

OIC Returns Indicate Lack of Communication

The high OIC return rates suggest that the IRS is not taking time to effectively communicate with taxpayers. In each fiscal year since COIC processing was adopted, the IRS has returned at least 57 percent of all OICs, either before or after accepting them for processing.[35] Seventy-two percent of OICs that were not processable in FY 2003 (and 41 percent in FY 2004) were given this classification because the taxpayer had not filed all required tax returns, as shown on Table 1.19.2, Reasons for "Not Processable" OIC Returns, below. Communicating with taxpayers and giving them a reasonable period of time to file any delinquent tax returns prior to returning an OIC would reduce erroneous OIC returns, educate taxpayers, and enable the IRS to both collect money being offered and secure delinquent returns in one fell swoop![36]

---

[33] SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, September 2004, 3.

[34] In November 2001, SB/SE Research warned that "[c]ompliance should consider monitoring the OIC cases that are returned to customers to make sure that offers examiners and offers specialists are not exceeding the return criteria in order to lower inventory levels. While returning a case may help short-term with OIC inventory levels, it harms customer satisfaction and causes the IRS to handle the same offers several times instead of just once." SB/SE Research Headquarters, *Offer in Compromise – Centralized Processing Profile*, Project 13.29 Final Report, 17 (November 2001).

[35] SB/SE, Offer in Compromise Program, Executive Summary for the Oversight Board, FY 2001 through FY 2004.

[36] IRS currently returns OICs from nonfilers even if no tax was due for the period of nonfiling. See IRM 5.8.3.4.1 (Rev. 5-15-2004).

TABLE 1.19.2, REASONS FOR "NOT PROCESSABLE" OIC RETURNS[37]

Reason	FY 2003		FY 2004	
Returns not filed	21,752	72%	15,905	41%
Open bankruptcy proceeding	4,882	16%	3,501	9%
Form 433-A not included	2,855	9%	3,823	10%
Previous 2 quarters of employment tax not filed/paid	1,969	6%	1,664	4%
Obsolete Form 656	1,137	4%	333	1%
Obsolete Form 433-A/B	1,111	4%	320	1%
Current employment tax deposit not timely	880	3%	694	2%
Form 433-B not included	164	1%	353	1%
Not a verbatim duplicate	33	0%	125	0%
Fee not with offer	0	0%	20,688	54%
Returns not filed - both spouses	0	0%	1,020	3%

A lack of communication also contributes to the high rate of OICs returned after acceptance for processing. Sixty-seven percent of OICs that were returned after acceptance for processing in FY 2003 (and 61 percent in FY 2004) were returned because, according to the IRS, the taxpayer did not submit sufficient financial verification, as shown on Table 1.19.3, Reasons for OIC Returns after Acceptance for Processing, below. The statistics do not indicate the extent to which the IRS contacted taxpayers and their representatives to obtain sufficient financial verification, whether those efforts were reasonable, or whether the verification that the IRS was seeking was reasonable.[38] Practitioners tell us that in some cases the IRS is returning offers without any apparent attempts to communicate with the taxpayer or their representative, and in other cases COIC employees place calls into different time zones or during COIC "swing shifts" outside of the hours during which the taxpayer or representative may reasonably be available. Regardless of whether IRS or taxpayers are responsible for communication failures in a given instance, the IRS could reduce OIC returns by increasing communication with taxpayers and their representatives.

The IRS, however, intentionally reduced communication attempts before returning offers from "at least two" to one so that it could reduce the time employees spend processing

[37] SB/SE, Automated Offer In Compromise 4196 Report, FY 2003 and FY 2004. Because OICs are sometimes returned for multiple reasons, these numbers exceed the total number of OICs returned as "not processable" and these percentages exceed 100 percent. The percentages were calculated by dividing the returns in each category by the total number of OICs returned as "not processable," as shown in Table 1.19.1, OIC Dispositions, Fiscal Year Comparison.

[38] The IRS may return an offer for insufficient information after a single request has been made by phone, in person or by letter when the information is not received by the deadline set by the IRS employee. IRM 5.7.2.2.2 (Rev. 5-15-2004). Practitioners have suggested that IRS' OIC return policies are unreasonable. *See, e.g.*, Brant Goldwyn, *Dispute Resolution: IRS Revises OIC Letters Sent to Taxpayers; Practitioners Advise IRS of OIC Concerns*, 20 DAILY TAX REPORT G-7 (Feb. 2, 2004) (stating that "[b]y not giving additional time or calling practitioners and explaining what's needed, [IRS is] seizing the opportunity to return the offer"). However, IRS procedures now allow for some additional communication before returning offers based upon inadequate expense documentation in cases where the taxpayer has substantially responded to the IRS' information request. *See* IRM 5.8.3.16 (Rev. 11-15-2004).

OIC submissions that it deemed not to be serious.[39] The premise of this decision was that returning offers would allow IRS employees to consider serious OICs more quickly.[40] It was never contemplated that serious offers would be returned without reasonable communication attempts. The IRS has not determined whether reduced communications have actually resulted in faster substantive evaluation of other OICs or saved IRS resources.[41]

TABLE 1.19.3, REASONS FOR OIC RETURNS AFTER ACCEPTANCE FOR PROCESSING[42]

Reason	FY 2003		FY 2004	
Financial verification not provided	39,915	67%	19,656	61%
Estimated tax payments not made	4,736	10%	4,337	13%
Returns not filed	4,624	9%	2,916	9%
Missing periods	1,272	3%	682	2%
No basis for compromise	1,070	2%	776	2%
Other pending investigation	1,053	2%	1,133	4%
Current employment tax deposit not timely	1,034	2%	857	3%
Previous 2 quarters of employment tax not filed/paid	903	2%	609	2%
Open bankruptcy proceeding	804	2%	479	1%
Financial verification nonliable party	758	2%	521	2%
To delay collections	749	2%	784	2%
Form 433-a missing information	619	1%	290	1%
Resubmission of prior rej/ret offer	511	1%	585	2%
Erroneous periods included	448	1%	242	1%
Form 433-a not included	400	1%	177	1%
More than the balance due	303	1%	159	0%
Obsolete form 656	296	1%	75	0%
Offer amount not entered	293	1%	119	0%
Payment terms missing	248	1%	91	0%
Form 433-b not included	233	0%	165	1%
Waiver of fee not substantiated	0	0%	447	1%
Dishonored check for user fee	0	0%	282	1%

[39] *See* General Accounting Office, *IRS Should Evaluate the Changes to Its Offer in Compromise Program*, GAO-02-311, 24-25 (March 15, 2002).

[40] *See id*.

[41] In the context of Earned Income Tax Credit (EITC) audits, a recent study suggested that increased up-front communications with taxpayers may reduce IRS expenses by reducing audit reconsideration requests. National Taxpayer Advocate, *Annual Report to Congress Volume II, The National Taxpayer Advocate's Earned Income Tax Credit (EITC) Audit Reconsideration Study*, Publication 2104, (Rev. 12-2004) 6, 13-16. Similarly, increased up-front communication might reduce the cost of OIC processing by reducing offer resubmissions and Appeals.

[42] SB/SE, Automated Offer In Compromise 4196 Report, FY 2003 and FY 2004. Because OICs are sometimes returned for multiple reasons, these numbers exceed the total number of OICs returned after acceptance for processing and these percentages exceed 100 percent. The percentages were calculated by dividing the returns in each category by the total number of OICs returned after acceptance for processing, as shown in Table 1.19.1, OIC Dispositions, Fiscal Year Comparison. Items representing less than one percent are not included.

OIC Form Revision May Reduce Returns

In July 2004 the IRS made progress in improving communication with taxpayers by revising its OIC form (Form 656). The new form was developed with comments from the Taxpayer Advocate Service (TAS) and practitioner groups. The revised form may help to reduce OIC returns resulting from the failure to include a user fee with the OIC application because the user fee requirement is clearly stated on the new form.[43] It may also be helpful in reducing OIC returns based on the failure to have filed all tax returns because the new form has space for taxpayers to include an explanation if they were not legally required to file a return.[44] While additional revisions could make the OIC forms and worksheets even less complex and confusing for taxpayers, the new form is an improvement.

OIC User Fee is an Unintended Barrier to OIC Processing

The user fee has become a barrier to OIC processing, which exacerbates the problem of OIC returns.[45] The fee was not intended to be a barrier to OIC processing or to multiply the burden associated with the return of an OIC to a cooperative taxpayer. It was intended to reduce the number of frivolous offers as well as the number withdrawn, returned, or rejected because the taxpayer would not provide adequate information for the IRS to process the offer or would not offer an amount that reflected the taxpayer's ability to pay.[46] When they issued the user fee regulations, the IRS and the Treasury Department assumed that once an offer was accepted for processing, the IRS would "work closely with taxpayers to perfect incomplete or inadequate offers before returning or rejecting them,"[47] thereby avoiding unnecessary returns based upon a lack of reasonable communication. To the extent a lack of reasonable communication by the IRS is responsible for OIC returns, the fee is being imposed, sometimes multiple times, in cases where it was not intended to be imposed at all.[48]

[43] Form 656, *Offer in Compromise* (Rev. 7-2004) 2.

[44] *Id.*

[45] Between November 2003 (when the user fee became effective) and September 2004, 20,688 offers were returned because the taxpayer failed to include the fee or the waiver form, surpassing failure to file returns as the number one reason for offers to be not processable. SB/SE, Automated Offer In Compromise 4196 Report, FY 2004. However, a recent study suggests that the percentage of offers returned for failure to include the fee declined from over 60 percent in December 2003 to under 15 percent in July 2004. SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, 5-6 (Sept. 2004).

[46] T.D. 9086, 68 Fed. Reg. 48,785, 48,786 (Aug. 15, 2003) (preamble).

[47] *Id.*

[48] *See* Treasury Inspector General for Tax Administration, *Continued Progress Is Needed to Improve the Centralized Offer in Compromise Program*, Reference 2003-30-182, 1 (Sept. 2003) (indicating that 15 percent of the OICs returned after acceptance for processing were inappropriately returned); SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, 4-5 (Sept. 2004) (indicating that 24 percent of all resubmitted offers are ultimately accepted). In a recent case, married taxpayers submitted an OIC for both joint and separate liabilities with two fees ($300). It was erroneously returned after acceptance for processing because IRS believed the taxpayers had not filed all required returns. Even if the IRS had been correct that the taxpayers had not filed all returns, the OIC should have been returned with the fee before acceptance for processing. The taxpayers actually had no filing requirement for the years in question, but had to wait for IRS to process the OIC twice and resubmit the OIC with two more fees ($600 total) when a single phone call could have resolved the situation and allowed the OIC to be processed without additional fees or delay. Although TAS was able to get two of the fees ($300) abated, this process seemed unreasonable from the taxpayers' perspective.

Returning Offers Unnecessarily

The IRS sometimes unnecessarily returns an offer that could have been evaluated based on available information. For example, an OIC submission was returned because four out of 50-60 pages of the OIC packet, which were not needed to complete the analysis, were not received. The OIC was later resubmitted and rejected without the missing pages. The OIC was returned because IRS did not evaluate whether the missing information was needed to process the offer.[49] The decision to return an OIC amounts to a *de facto* rejection because the liability remains outstanding and IRS retains the fee, but the taxpayer is denied appeal rights that would be available if the OIC were rejected.[50] An IRS manager is required to sign the OIC return letter if the return is based upon a taxpayer's failure to provide requested financial information.[51] However, we understand that the level of managerial review that actually occurs in such cases is minimal and other OIC return decisions are not subject to review.[52] Thus, the IRS is not fully accountable for the reasonableness of its OIC return decisions.

Nonprocessability of OICs from Taxpayers in Bankruptcy

Another problem is that OICs from taxpayers in bankruptcy are not considered processable.[53] Nine percent of all "not processable" offers (and one percent of all offers returned after acceptance for processing) are returned because the taxpayer is in bankruptcy, as shown on Table 1.19.2 and Table 1.19.3. The reason given for this policy is that the IRS believes that its centralized "bulk processing" operations can not process an OIC under the time constraints likely to be imposed by bankruptcy courts.[54] From September 1999 through January 1, 2000, before COIC processing was adopted, the IRS processed OICs

[49] The few missing pages did not prevent the "reasonable collection potential" (RCP) from being calculated, so the OIC return was not in accordance with IRS procedure. IRM 5.8.3.16 (4) (Rev. 11-15-2004).

[50] See IRC § 7122(d) (providing for appeal of rejected OICs); Treas. Reg. § 301.7122-(f)(5)(i) (same); IRM 5.8.7.2 (Rev. 11-15-2004) (providing that in the case of a "processable return" the IRS will retain the OIC fee and the taxpayer will not receive appeal rights); Treas. Reg. § 301.7122-1(f)(5)(ii) (same). Under a new IRS process OIC returns will be reconsidered by SB/SE in limited circumstances, such as where there was a fire, flood, or death in the taxpayer's immediate family, which prevented the taxpayer from meeting IRS deadlines for submission of information. *See* IRM 5.8.7.3 (Rev. 11-15-2004).

[51] IRM 5.8.7.2.2 (Rev. 11-15-2004). *See also* Treas. Reg. 301.7122-(f)(5)(ii).

[52] IRM 5.8.7.2.2 (Rev. 11-15-2004).

[53] Rev. Proc. 2003-71, 2003-36 I.R.B. 517 § 5.01; Form 656, Offer in Compromise (Rev. 7-2004), 2.

[54] *See* Chief Counsel Notice CC-2004-025 (July 12, 2004) (explaining that "[t]imeframes for the consideration of claims and payment proposals in a bankruptcy case do not mesh with the bulk processing operations established for the high volume of administrative offers in compromise received by the Service."); IRM 25.17.4.7 (Rev. 7-01-2002) (stating that "[t]oo many administrative and legal problems would be created if a tax liability was simultaneously the subject of a court-supervised bankruptcy case and the administrative offer-in-compromise process."). The IRS could also be concerned that any compromise made in connection with a bankruptcy would primarily benefit other creditors rather than the taxpayer, but its policy of excluding taxpayers from the OIC process is not limited to taxpayers facing such situations.

from taxpayers in bankruptcy.[55] Processing such offers during that period must have been determined to be feasible before the IRS adopted its current centralized "bulk processing" operations. Thus, IRS' extensive use of centralization and "bulk processing" appears to be driving its current policy of excluding bankrupt taxpayers from the OIC process.

The IRS' policy, however, denies taxpayers the ability to have their OICs considered, and in so doing, effectively denies them a "fresh start" towards future compliance even after completing a bankruptcy proceeding, which is specifically designed for that purpose.[56] Perhaps this is one reason bankruptcy courts have rejected IRS' policy, overturning it in a number of cases by requiring OICs from bankrupt taxpayers to be processed.[57]

In response to court decisions overturning IRS' policy of not processing OICs from taxpayers in bankruptcy, the IRS Office of Chief Counsel recently issued a notice indicating that, in lieu of considering an OIC, the IRS would in limited circumstances consider accepting less than the debtor would otherwise be required to pay under the Bankruptcy Code in the context of approving a bankruptcy plan.[58] The IRS will not agree to accept less, however, unless no lower priority creditor is paid.[59] This policy applies even if paying a lower priority creditor is necessary for the production of income or otherwise makes sense for the government.[60] The reason for such inflexibility is not explained. In addition, under its new procedures the IRS will not consider confirming a bankruptcy plan based upon Effective Tax Administration considerations, even if those considerations would theoretically be considered in connection with an OIC outside of bankruptcy.[61]

Restrictions on Acceptable Offers Unlikely to Increase Collections

OICs based upon "doubt as to collectibility" (DATC) that are not returned are subject to a rigid evaluation process that in some cases ignores reality. To the extent this process reduces the IRS' ability to realistically evaluate each individual offer, it is inconsistent with the IRS' goal of collecting liabilities at the earliest possible time and at the least cost to the government.[62] The overall result of several IRS OIC policies can be illustrated by the following example.

[55] *See* CCA 200011046 (March 17, 2000).

[56] *See Burlingham v Crouse*, 228 US 459, 473 (1913). *See also* Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong, 1st Sess, pt 1, 75, 68-83 (1973).

[57] *See In re Macher*, 303 B.R. 798 (W.D. Va. 2003), *nonacq*., 2004-32 I.R.B. 154 (Aug. 9, 2004); *In re Holmes*, 298 B.R. 477 (M.D. Ga. 2003), *aff'd*, 309 B.R. 824 (M.D. Ga. 2004); *In re Mills*, 240 B.R. 689 (S.D. W.V. 1999); *In re Chapman*, 84 A.F.T.R. 2d 99-5271, 99-2 U.S.T.C.¶50,690 (Bankr. S.D. W.V. 1999).

[58] *See* Chief Counsel Notice CC-2004-025 (July 12, 2004).

[59] *See id*.

[60] *See id*.

[61] The standard criteria for evaluating an OIC will not be used to evaluate plans/offers submitted by taxpayers in bankruptcy. *See id*. The criteria IRS will use for evaluating plans/offers submitted in bankruptcy is whether the plan/offer is in the government's best interest, subject to various unexplained limitations. *Id*. This combination of general acceptance criteria and specific limitations is likely to result in the acceptance of few plans/offers under the new criteria.

[62] Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. 1-30-1992).

> **Example:** A taxpayer filed an offer for $15,000, to be funded by loans from relatives. The IRS returned the offer because the taxpayer was in bankruptcy. Following bankruptcy, he submitted the OIC again, but it was rejected on the grounds that the taxpayer needed to increase the offer amount to more than $28,000. Due to the taxpayer's bankruptcy and financial condition, he could not borrow the suggested amount. The decision was sustained by Appeals. The IRS later classified the taxpayer's account as "currently not collectible" based on his financial statement indicating that his necessary living expenses exceeded his monthly income. Because the IRS returned the offer, the taxpayer had to spend the time and resources to submit it twice; and by returning and rejecting the offer, the IRS had to process it twice and ultimately lost the opportunity to collect $15,000 in cash.

At the National Taxpayer Advocate's request, SB/SE agreed to work with the IRS' Office of Program Evaluation, Research, and Analysis (OPERA) to study the outcome of rejected offers.[63] This study confirms that by returning and rejecting OICs, the IRS is missing opportunities to collect what can reasonably be collected at the earliest possible time and at the least cost to the government.[64]

Rejection of OICs in Favor of Extended Installment Agreements

An offer based upon doubt as to collectibility will be summarily rejected if, based upon the IRS' projections of the taxpayer's future income, he or she could fully pay the liability within the original collection statute of limitations period **plus five years**.[65] This is because such taxpayers qualify for long-term installment agreements.[66] As an illustration, consider the following two hypothetical cases:

> **Example:** In both cases, ten years remain until the collection statute of limitations expiration date (CSED). In the first, the IRS projects that the taxpayer could fully pay the liability within 15 years. Because the taxpayer could fully pay within the CSED plus five years the IRS will reject the tax-

[63] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), 17; National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 101.

[64] SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, 11 (Sept. 2004).

[65] *See* IRM 5.8.1.1.3 (Rev. 11-15-2004) (stating: "Offers will not be accepted if it is believed that the liability can be paid in full as a lump sum or under current installment agreement guidelines."); IRM 5.8.3.12(2) (Rev. 5-15-2004) (same); IRM 5.8.4.5 (Rev. 11-15-2004) (same); IRM 5.14.2.1 (Rev. 3-30-2002) (providing that to be eligible for an installment agreement a taxpayer must full pay within the collection statute of limitations period, which the IRS will extend for up to 5 years); IRM 25.6.18.2 (Rev.10-1-2002) (same).

[66] *Id*. Section 843 of the American Jobs Creation Act of 2004 (P.L. 108-357), allows partial payment installment agreements, consistent with the recommendation of the National Taxpayer Advocate. See National Taxpayer Advocate, *FY 2001 Annual Report to Congress*, Publication 2104 (Rev. 12-2001), 210-214. While the new law is likely to reduce the number of offers submitted, it remains to be seen how it will affect IRS' existing offer policy. TAS will be monitoring IRS' implementation of the new law to ensure that it is not used to reduce access to the OIC program.

> payer's OIC.[67] In the second, the IRS projects that the taxpayer could fully pay the liability in 16 years. Because he could not fully pay within the CSED plus five years, he is eligible for an OIC requiring him to pay an amount that only takes into account his future income for four or five years, depending on the OIC payment terms.[68]

This policy may have particularly harsh consequences when full payment of the liability would subject the taxpayer to "economic hardship"[69] because the IRS' internal guidance does not make it clear that economic hardship should be taken into account in this "full pay" determination, even though it would be taken into account in determining an acceptable offer amount after the "full pay" determination.[70] OICs are intended as an alternative to both protracted installment agreements and placing taxpayers in "currently not collectible" (CNC) status based on the IRS' implicit determination that "protracted installment agreements" and CNC status are less effective in collecting liabilities and in promoting future compliance.[71] An IRS study recently concluded that the "CSED plus five" policy should be eliminated based upon evidence that it may actually reduce collections.[72]

> **Example:** A 72-year-old taxpayer with severe mental and physical disabilities offered to pay over $2,000 to settle a $22,000 liability. A COIC employee rejected the offer because he or she projected that the taxpayer could "full pay" the liability over almost **14 years**. The calculations

[67] If this can be determined based upon information submitted by the taxpayer, no communication with the taxpayer is required prior to rejecting the offer. IRM 5.8.4.5 (Rev. 11-15-2004).

[68] Form 656, Offer in Compromise (Rev. 7-2004), 6-7; IRM 5.8.5.5.4(2) (Rev. 11-15-2004).

[69] An "economic hardship" is the inability to meet basic living expenses. Treas. Reg. § 301.6343-1(b)(4);Treas. Reg. § 301.7122-1(b)(3). In addition, factors such as the taxpayer's age and employment status; number, age and health of the taxpayer's dependents; cost of living in the area the taxpayer resides; and any extraordinary circumstances such as special education expenses, a medical catastrophe or natural disaster may be taken into account. IRM 5.8.11.2.1(5) (Rev. 5-15-2004).

[70] *See* IRM 5.8.1.1.3(2) (Rev. 11-15-2004) (prohibiting acceptance, without exception for hardship); IRM 5.8.1.1.3(3) (Rev. 11-15-2004) (discussing hardship, but not indicating relevance to the full pay analysis); IRM 5.8.3.12(2) (Rev. 5-15-2004) (no exception); IRM 5.8.4.4(3) (Rev. 11-15-2004) (no exception); IRM 5.8.4.5(2) (Rev. 11-15-2004) (no exception); IRM 5.8.4.5(3) (Rev. 11-15-2004) (discussion of special circumstances, but not indicating relevance to full pay analysis); IRM 5.8.4.6 (Rev. 11-15-2004) (conflicting flow chart entries); IRM 5.14.2.1(15)(d) (Rev. 3-30-2002) (vague exception for "age or ill health," but not indicating relevance to full pay analysis); IRM 5.8.11.2(1) (Rev. 5-15-2004) (discussing compromise based on hardship where full payment is possible, but not indicating relevance to full pay analysis process). Even if economic hardship is taken into account in the full pay analysis, IRS is unlikely to be able to fully evaluate it without communicating with the taxpayer (which is not done in connection with the full pay analysis) since the analysis may involve subjective judgments about the extent of the hardship that is created by collection.

[71] *See* SB/SE Payment Compliance and OPERA, *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, September 2004, 11-13. See also, Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. 1-30-1992); Form 656, Offer in Compromise (Rev. 7-2004), p 1. However, IRS has recently redefined the term "protracted" so as to lose all restrictive meaning. See IRM 5.8.1.1.3(1) (Rev. 11-15-2004) (stating that "a protracted installment agreement is defined as being one that extends beyond the period allowed under IRS issued guidelines.").

[72] SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, September 2004, 11-13.

> assumed that the taxpayer could access the equity in his mobile home, even though a second mortgage or refinancing would be impossible. The employee also assumed that the taxpayer could access equity in his car, even though the car loan exceeded the car's blue book value. In addition, the IRS's analysis did not address economic hardship. A few months after the offer was rejected the taxpayer's account was placed in CNC status and the taxpayer died.

Calculating a Reasonable Offer Amount

The IRS continues to have difficulty calculating a reasonable offer amount.[73] Absent special circumstances, the IRS will not accept an OIC based upon DATC unless the taxpayer offers to pay his or her "reasonable collection potential" (RCP).[74] A taxpayer's RCP equals the net equity in the taxpayer's assets plus the amount the IRS could collect from his or her future income (less necessary living expenses) over a set number of months (48 months, 60 months, or the period remaining before expiration of the collection statute of limitations period, depending on the type of offer).[75] If RCP is not calculated utilizing reasonable assumptions, many offers will be unnecessarily rejected. A recent IRS study has concluded that the IRS needs to reevaluate its method of determining reasonable collection potential because the significant number of taxpayers in CNC status who cannot qualify for an OIC suggest that the RCP does not actually reflect the "reasonable" collection potential.[76]

Declining OIC Acceptance Rate Unexplained

The unexplained reduction in OIC acceptance rates, from 39 percent in FY 2001 before COIC was adopted to 16 percent in FY 2004, as shown on Table 1.19.1, OIC Dispositions, Fiscal Year Comparison, suggests that OIC acceptance policies have become stricter, decision quality in the COIC program is declining, or taxpayers have become less reasonable in making offers. If quality is improving, the declining acceptance rate suggests that the IRS has a deteriorating taxpayer communication problem (prompting taxpayers to submit unrealistic OICs) or continues to adopt policies that result in the rejection of reasonable OICs.[77] IRS should research the declining OIC acceptance rates to determine the cause.

[73] According to IRS quality measures, the IRS' ability to determine the correct offer amount declined from 67 percent in FY 2001 (before COIC processing) to 58 percent in FY 2003. SB/SE Performance Measurement, Collection Quality Measurement System (CQMS) database, Closed Date Compressed Report – National Results, FY 2001 and FY 2003. IRS has no statistics to indicate whether COIC decision quality has improved in FY 2004 or continued to decline.

[74] *See* Form 656, Offer In Compromise (Rev. 7-2004) 5. "Special circumstances" are commonly based on an "economic hardship," described above. IRM 5.8.11.2.1(2) (Rev. 5-15-2004).

[75] *See* Form 656, Offer In Compromise (Rev. 7-2004) 6.

[76] SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, 13 (Sept. 2004).

[77] It is possible that misinformation is being disseminated by a few practitioners, but that would also be a communications/enforcement problem that the IRS should identify and address.

Calculating RCP – Deviating from Expenses Guidelines

Taxpayers and practitioners complain that IRS employees sometimes strictly adhere to the expense guidelines, notwithstanding facts and circumstances which indicate that they are not appropriate in a given case.[78] The RCP is determined based in part on an analysis of the taxpayer's basic living expenses.[79] The IRS established national and local standards as guidelines for certain expenses such as groceries, household expenses, housing and transportation.[80] Despite these guidelines, the Code requires IRS employees to evaluate the facts and circumstances of each taxpayer in determining an acceptable offer amount.[81]

One recent court case illustrates a rigid application of the expense guidelines. In *Fowler v. Commissioner*, T.C. Memo 2004-163, the taxpayer submitted an OIC for $2,400 to be paid in monthly installments of $100. The IRS determined the minimum acceptable amount was a lump sum of $2,400 based on the value of the taxpayer's automobile, decided the taxpayer could not make the $100 payments over time, and rejected the offer. In making this determination, IRS used the national standard expenses, which were higher than the expenses claimed by the taxpayer. The Tax Court held that use of the national standards was an abuse of discretion, noting that there was no explanation of why the taxpayer's expenses were too low or why the national standard expenses were more accurate. While one case is not conclusive, the fact that the IRS did not take a realistic look at the taxpayer's offer, provide a convincing rationale for its decision or settle this case (which was not decided within two years) suggests that in some cases IRS may be having difficulty deviating from the expense standards.

Another recent case suggests that IRS' difficulty in accepting a taxpayer's claimed expenses (rather than using the expense guidelines) sometimes results from documentation requirements that are not clearly communicated to the taxpayer.

> **Example:** An offer submitted by a 72-year-old taxpayer was rejected based upon the disallowance of expenses such as transportation (cab fares), over-the-counter drugs and insurance premiums, which were not documented to SB/SE's satisfaction. On appeal the OIC was accepted for an amount significantly less than required by SB/SE because TAS worked with the taxpayer to obtain further documentation of his expenses. The OIC could have been more realistically evaluated and accepted without the necessity of an appeal if time had been taken to communicate IRS documentation requirements more clearly to this elderly taxpayer.

[78] *See, e.g.*, 2003 Nationwide Tax Forum Focus Groups Customer Satisfaction Issues of Practitioners, Project 01.08.005.03, 4; Robert Zarzar, *AICPA Submits Survey Results On Offer In Compromise Program*, 2003 TNT 200-38 (Oct. 15, 2003) (providing survey results reflecting the "nearly unanimous" opinion of surveyed AICPA members that the IRS is intentionally looking for reasons to reject an OIC).

[79] *See* Form 656, Offer In Compromise (Rev. 7-2004) 5.

[80] IRM 5.15.1(7) (Rev. 11-15-2004).

[81] IRC § 7122(c)(2); Treas. Reg. § 301.7122-1(c).

SB/SE should evaluate the extent to which its perceived inflexibility in deviating from the expense guidelines results from a practice of imposing unnecessary substantiation requirements or from a failure to effectively communicate the requirements to taxpayers or their representatives.

Calculating RCP – Determining the Number of Months of Future Income

The amount of future income to be taken into account in determining an acceptable offer amount depends upon how quickly the taxpayer proposes to pay the liability.[82] Regardless of the payment period a taxpayer is never required to offer an amount that the IRS could collect out of future income for a period beyond the end of the statutory period for collecting the tax. However, we have been advised by practitioners that campuses sometimes reject offers that do not take into account future income over 48 or 60 month periods, regardless of how many months are actually left on the statutory period for collection.[83]

Calculating RCP – Future Income Projection

The Internal Revenue Manual maintains a rigid income-averaging calculation as the basis for determining future income for sporadic earners, even though other estimates may prove to be more accurate.[84] That is, the future income of a taxpayer who is currently unemployed may be calculated based on his or her past earning history, regardless of job market prospects or other external factors. This policy may also result, for example, in the assumption that income from a one-time windfall will be received again in the future. This approach will lead the IRS to reject reasonable offers because it ignores the facts of the taxpayer's case in determining a reasonable offer amount.

Calculating RCP – Excluding State Tax Expenses

The IRS' treatment of state and local tax expenses in calculating RCP is also unrealistic. In calculating future income, monthly payments to state or local taxing agencies for delinquent taxes are not taken into account as expenses, even if the state or local taxing agency is collecting funds through a wage attachment or installment agreement.[85] In contrast, the IRS allows these expenses when calculating future income for an installment agreement that provides for full payment of the liability.[86]

[82] Form 656, Offer in Compromise (Rev. 7-2004), 6-7; IRM 5.8.5.5.4(2) (Rev. 11-15-2004).

[83] Perhaps this is a result of the oversimplification provided in IRM 5.8.5.5(1) and IRM 5.8.5.6(2), which state the general 48 and 60 month rules but omit the important exception found in IRM 5.8.5.5.4 that "for cash and short term deferred offers, when there are less than 48 or 60 months remaining on the statutory period for collection, use the number of months remaining." In addition, one version of the software used by SB/SE personnel to estimate a taxpayer's ability to pay erroneously provides that "48 months is the minimum factor used to calculate future payment ability per OIC guidelines."

[84] IRM 5.8.5.5(5) (Rev. 11-15-2004); IRM 5.8.5.5(6) (Rev. 11-15-2004). By "sporadic earner" we mean persons with a history of irregular employment or income. In many such cases, the use of a collateral agreement is a reasonable alternative to income averaging. A collateral agreement requires a taxpayer to provide additional consideration for an offer in compromise in the event that the taxpayer's future income exceeds agreed thresholds. *See* Form 2261, Collateral Agreement - Future Income (Individual) (Rev. 4-1995); IRM 8.13.2.4.6 (Rev. 6-8-2000).

[85] *See* IRM 5.8.5.5.2(8) (Rev. 11-15-2004); IRM Exhibit 5.15.1-2 (Rev. 3-31-2000); IRM Exhibit 5.19.1-12 (Rev. 12-15-2002).

[86] *See* IRM 5.8.5.5.2(8) (Rev. 11-15-2004).

The IRS' rationale for excluding delinquent state and local tax expenses from the OIC RCP calculation is that a federal tax lien would take priority over a state tax lien on future income in the context of enforced collection.[87] The IRS may have concluded that allowing such expenses in cases where the IRS accepts less than full payment gives the state and local authorities a greater priority than they would receive in the context of enforced collection at the expense of the federal government. However, this reasoning ignores the fact that the OIC program is an alternative to enforced collection. Unless the government determines that its interest is best served by enforced collection, the priority of the federal government's tax lien on future income is not determinative of what constitutes a reasonable offer.

Alternatively, the IRS could have concluded that a taxpayer's remedy is to negotiate with the state and local authorities. However, this is unrealistic because the IRS' future income formula allows for no amount to be paid to state and local authorities, and so it leaves no room for compromise. The IRS' disallowance of state and local tax expenses is likely to drive taxpayers out of the OIC program even in cases where the IRS would collect a smaller amount through bankruptcy or through enforced collection (*e.g.*, because the taxpayer is funding the offer, in part, with exempt assets or assets from friends or family). This policy will not help the IRS reach a reasonable settlement with taxpayers, and may not make sense if IRS collects less than half of the amount offered in 44 percent of the rejected offers from individuals, as suggested by a recent study.[88]

Appeals' Response to Increasing OICs

As OIC rejections have increased, so have OIC appeals.[89] OIC appeals make up an increasing percentage of Appeals' total case receipts, rising from about ten percent in fiscal year 2002 to about 17 percent in fiscal year 2004.[90] Appeals has responded to increasing OIC receipts by increasing its focus on cycle time.[91] It reports reducing its OIC cycle time by 25 percent since May 2002.[92] Appeals' cycle time reduction initiatives include moving the majority of its OIC work to the campuses.[93]

[87] IRM 5.8.5.5.2(8) (Rev. 11-15-2004).

[88] SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), *IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program*, 8, 11 (Sept. 2004).

[89] Taxpayers appeal about 58 percent of all rejected OICs. Letter from Mark W. Everson, Commissioner, Internal Revenue Service, to Charles E. Grassley, Chairman, Committee on Finance, United States Senate, 4 (Oct. 28, 2004).

[90] IRS, Business Performance Management System, *Key Statistical Chart for Appeals*, FY 2002 and FY 2004. No comparable statistics are available for FY 2001 prior to the adoption of COIC.

[91] IRS, Roadmap to Success – Guidance to Appeals Field Operations FY 2004, 10.

[92] IRS, Business Performance Review, Appeals Division, 9, (Feb. 24, 2004).

[93] *Id*., at 15. In addition, Appeals has directed its Area Directors to require taxpayers to provide any additional information in no more than 30 days. IRS, Roadmap to Success – Guidance to Appeals Field Operations FY 2004, 10. This presents fairness issues for taxpayers whose cases have languished in Appeals' inventory for more than a year and for whom responding within the 30 day period may present a hardship.

However, survey results show that Appeals' OIC customers are more dissatisfied with Appeals than other customers exposed to the Appeals process.[94] The survey indicates that the highest priority of both satisfied and dissatisfied customers was "fairness in resolving your case."[95] Thus, any reductions in cycle time that come at the expense of fairness, as increasing use of campus processing could, are unlikely to improve customer satisfaction.

Appeals could further reduce its OIC inventory without sacrificing customer satisfaction by assisting SB/SE in improving its OIC decision quality. Appeals accepts offers from about 28 percent of taxpayers appealing a rejection by SB/SE.[96] Since Appeals employees are reviewing the work of SB/SE employees when they review OIC appeals, they are in an excellent position to identify areas where SB/SE makes the most frequent errors (or at least areas where Appeals and SB/SE disagree). Appeals refers many of the OICs that it accepts to a quality reviewer and is undertaking a more comprehensive review of these offers to identify areas where Appeals and SB/SE may have differing views of the IRM.[97] We commend these efforts. However, Appeals could further reduce its OIC inventory by routinely and systematically identifying areas where SB/SE employees make frequent errors (or, if not errors, where Appeals and SB/SE have disagreement) so that SB/SE can focus its training and guidance efforts accordingly. Appeals could track the reasons for reversing SB/SE's OIC rejections on a computer database so that SB/SE could quickly identify problem areas and take immediate corrective action. This might improve the quality of SB/SE decisions, increase the number of OICs accepted by SB/SE, and reduce OIC appeals.[98]

Non-Hardship Effective Tax Administration (ETA) Offers

The IRS remains unable or unwilling to accept ETA offers based upon equity and public policy considerations.[99] In FY 2004, a single offer was accepted by the IRS' ETA offer group, which is responsible for processing them. In addition, the IRS Office of Chief Counsel has declined the National Taxpayer Advocate's request to revise the ETA regulations under IRC § 7122 to provide more specific guidance regarding how ETA authority

[94] Pacific Consulting Group, *IRS Customer Satisfaction Survey, Appeals National Report, April through September 2003*, Appendix B-3 (January 2004), 42. According to the survey results, 28 percent of the respondents were dissatisfied with all Appeals programs versus 49 percent who were dissatisfied with Appeals' OIC program.

[95] *Id.* at 29, 30. "Fairness" was an even higher priority than the length of the process for both groups of taxpayers.

[96] E-mail response to request for information from Director, Appeals Tax Policy and Procedure (SB/SE and W&I) (Nov. 8, 2004). Some such acceptances may have resulted from the submission of new information, such as a new financial statement that reflects a deteriorating financial situation, or an increase in the offer amount, rather than improper rejections by SB/SE.

[97] E-mail response to request for information from Director Appeals Tax Policy and Procedure (SB/SE and W&I) (Sept. 22, 2004).

[98] In addition, Appeals could further promote and improve the Fast Track Mediation program, as discussed in the Most Serious Problem entitled IRS Mediation Programs, *infra*.

[99] This was previously discussed in the National Taxpayer Advocate's June 2004 report. See National Taxpayer Advocate, *Fiscal Year 2005 Objectives Report to Congress*, Publication 4054 (Rev. 06-2004), 7-15. These same considerations are also supposed to be applied to offers based upon doubt as to collectibility with special circumstances. IRM 5.8.11.2 (Rev. 5-15-2004).

should be used. The National Taxpayer Advocate believes that the IRS' narrow interpretation of the scope of ETA, as discussed in the National Taxpayer Advocate's June 2004 report, is wrong and ignores relevant legislative history.[100]

Instead, the National Taxpayer Advocate believes that IRS policies have narrowly construed equity and public policy (i.e., non-hardship ETA offers) as a basis for compromise, and that the specific circumstances under which IRS would accept a non-hardship ETA offer are unclear.[101] In the Joint Review of Non-Hardship ETA Program Cases, conducted in June 2004, TAS reviewed the portions of case files sent to the ETA group.[102] Facts relevant to the analysis were missing in many of the case files.[103] Because IRS has not provided significant specific guidance, other that the examples in the regulations, regarding when non-hardship ETA offers should be accepted, it is difficult for both IRS personnel and taxpayers to focus on relevant facts and circumstances. If the applicability of non-hardship ETA remains a mystery, as a practical matter, it will cease to exist. The National Taxpayer Advocate believes that legislation is required to keep IRS from essentially eliminating non-hardship ETA offers as a basis for compromise. Such a legislative proposal, titled Offer in Compromise: Effective Tax Administration, is provided in section 2 of this report.

Hardship Effective Tax Administration (ETA) Offers

The IRS has provided little specific guidance, other than the examples in the regulations, to assist taxpayers and IRS employees in determining when compromise based upon economic hardship is appropriate.[104] An analysis of economic hardship may involve an evaluation of future expenses which are difficult to project and document, making the IRS reluctant to consider them. According to Appeals, analyzing doubt as to collectibility offers with special circumstances (which generally involve an economic hardship analysis) is an area where SB/SE and Appeals most frequently have differing opinions.[105]

[100] The conference report for the ETA legislation stated, "[t]he conferees expect that the present regulations will be expanded so as to permit the IRS, in certain circumstances, to consider additional factors (*i.e.*, factors other than doubt as to liability or collectibility) in determining whether to compromise the income tax liabilities of individual taxpayers. For example, the conferees anticipate that the IRS will take into account factors such as equity, hardship, and public policy where a compromise of an individual taxpayer's income tax liability would promote effective tax administration. The conferees anticipate that, among other situations, the IRS may utilize this new authority to resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability." H.R. Conf. Rep. 599, 105th Cong., 2d Sess. 289 (1998).

[101] *See generally* Treas. Reg. § 301.7122-1(b)(3); IRM 5.8.11 (Rev. 5-15-2004).

[102] The purpose of this review was not to identify cases that were decided incorrectly. Because IRS has no specific standards for determining when to accept a non-hardship ETA offer and taxpayers have no guidance regarding which facts are relevant, such an exercise would have required further factual development and an analysis of legal arguments that had not been developed by taxpayers. This would have been impractical.

[103] Facts that the NTA believes should be relevant to the analysis are described in the legislative proposal entitled Offer in Compromise: Effective Tax Administration, *infra*.

[104] *See generally* Treas. Reg. § 301.7122-1(b)(3); IRM 5.8.11.2 (Rev. 5-15-2004).

[105] E-mail response to request for information from Director, Appeals Tax Policy and Procedure (SB/SE and W&I) (Sept. 22, 2004).

This suggests the need for more guidance regarding the specific analysis that IRS will follow in determining when OICs should be accepted based upon economic hardship (under both ETA and doubt as to collectibility with special circumstances). Furthermore, because the National Taxpayer Advocate believes that the existing rules, which confine the hardships that may be considered to economic hardships of individual taxpayers are overly restrictive, a legislative proposal, entitled Offer in Compromise: Effective Tax Administration, is provided in section 2 of this report to expand those rules.

Combination Offers

In addition to submitting an offer solely on the basis of "doubt as to collectibility" (DATC), "doubt as to liability" (DATL), or in furtherance of "effective tax administration" (ETA), offers can be submitted based on any combination of the three (called a "combination offer").[106] When an OIC is submitted on the grounds of both DATL and DATC, IRS policy requires that the DATC claim be processed first.[107] The OIC may be returned based upon a failure to provide information that may be irrelevant to consideration of the DATL issues.[108] If the offer is accepted on the basis of DATC, DATL is not considered.[109] Thus, the current policy could result in a taxpayer agreeing to pay a debt that is not owed. SB/SE has agreed that this is a problem, but has yet to revise its procedures to address it.[110]

IRS COMMENTS

For the past several years, the National Taxpayer Advocate (NTA) has identified the Offer in Compromise (OIC) program as one of the "most serious problems" facing taxpayers in the area of tax administration. In response, the IRS has worked closely with the NTA to identify opportunities to improve the quality of OIC case decisions, the timeliness of resolving OIC cases, and the service provided to taxpayers attempting to use the OIC process to settle their tax debts. Less than one percent of all IRS collection cases are resolved through the OIC process and only about two percent of cases worked by the Taxpayer Advocate Service (TAS) involve OIC matters. Based on TAS' TAMIS database, this percentage has been consistent over the last three years.

During the past year, timeliness of processing OICs has continued to improve and backlogs of unassigned OIC cases have been virtually eliminated. Currently, the inventory of open OIC cases is at its lowest level since early 1999. In addition, the OIC application package,

[106] IRM 5.8.4.10(1) (Rev. 11-15-2004).

[107] IRM 5.8.4.10(3) (Rev. 11-15-2004).

[108] IRM 5.8.4.10(4) (Rev. 11-15-2004).

[109] *Id.*

[110] We understand that SB/SE's proposed solution is to ask the taxpayer if they want the doubt as to liability issues considered upon completion of the doubt as to collectibility analysis. E-mail from SB/SE, OIC Program Manager, Payment Compliance (Oct. 10, 2004). As we understand this proposal, the taxpayer could still be faced with the dilemma of either accepting an offer for more than the correct amount owed or waiting for the IRS to analyze the doubt as to liability issues.

Form 656, has been revised to improve the clarity of communications with taxpayers and practitioners regarding the requirements for submitting complete, processable OICs. Feedback from the practitioner community regarding this revision has been very positive.

Maintaining manageable inventory levels contributes to the IRS goal of making quality OIC case decisions in a timely manner. In November 2003, the IRS implemented the OIC application fee to help offset the significant costs of the OIC program and to discourage inappropriate or frivolous OIC submissions. In 2004, the IRS completed a major revision of the Internal Revenue Manual on OICs (IRM 5.8) to:

- provide more clarity in procedural direction,
- improve the quality of case decisions, and
- improve taxpayers' opportunities to communicate with the IRS regarding the processing of their offer cases, particularly in cases which the IRS plans to reject or return the OICs.

The IRS devoted considerable time and attention in FY 04 to outreach activities designed to increase the public's awareness of the proper role of the OIC as a collection alternative and to clarify the expectations and requirements for taxpayers to submit processable OICs that can be evaluated and resolved in a timely manner. In particular, the OIC page on the IRS web site is updated regularly and is now much easier for the public to find and navigate. The IRS executives and senior managers participated in numerous outreach sessions specifically addressing the OIC program, including the 2004 National Tax Forums. Additionally, the SB/SE Collection and the Taxpayer Education and Communication (TEC) cadre of speakers, who have been trained to address OIC issues, provided similar presentations at local and regional tax practitioner forums.

The IRS believes that many of the recommendations in the NTA's 2004 Annual Report would increase the costs of the OIC program significantly.

Background

The inventories of open OICs grew dramatically from 1992 to 2001. By 2001, even though revenue officer staff hours devoted to the program had more than doubled from the 1998 staffing levels, the IRS was continuing to fall behind in maintaining the currency of the OIC inventory, with large backlogs of OIC casework accumulating in every field office.

As a result of implementing the Centralized OIC processing sites in July 2001, and revising operating procedures to improve the efficiency of the OIC process, the IRS reversed the upward trends in inventory growth. Currently, the inventory of open OICs is at its lowest point since early 1999. The program remains a very costly one with over 1000 Collection personnel devoted to processing OICs. The IRS firmly believes that it is in the best interests of tax administration to ensure the OIC program is managed efficiently and provides quality service to those taxpayers who are sincerely attempting to resolve their tax problems through the OIC process.

COIC Efficiency and Returns

"Returns" generally fall into two categories - those returned before and those returned after the initial processability determination. For an offer to be processable, it must meet the following conditions:

1) the taxpayer must have filed all legally due and required tax returns;
2) a business taxpayer must be in full compliance with employment tax filing and payment requirements for the two quarters immediately preceding the submission of the OIC, as well as the current quarter;
3) the taxpayer cannot be involved in an open bankruptcy proceeding;
4) the OIC must include the $150 OIC application fee (or a Form 656-A requesting a waiver of the fee); and
5) the OIC must be submitted with the most current OIC application forms.

An OIC which does not meet all of these conditions is returned to the taxpayer, along with any associated application fee. If the taxpayer resolves the problem conditions, he or she submits a new OIC for consideration. The recently revised OIC application package, Form 656, gives considerable direction and guidance to taxpayers to help them avoid submitting OICs that are not processable. The IRS anticipates receiving fewer unprocessable OICs in FY 05.

The number of OICs returned to taxpayers as not processable increased significantly due to the implementation of the OIC application fee, peaking in December 2003 at 64 percent of OIC receipts (44 percent involved the application fee issue). Due to the IRS' increased communication efforts and taxpayers' increased familiarity with the fee requirement, the percentage of OICs that were returned as not processable decreased to 33 percent by September 2004. Fifteen percent of these returned receipts involved the application fee, and only eight percent were returned as unprocessable solely due to the fee issue.

Generally, a processable offer is returned when the taxpayer fails to provide complete and timely responses to the IRS requests for additional information. Since the IRS has already invested considerable resources in the processability determinations, application fee processing, and initial financial analysis of the OICs, the IRS retains the application fee. If a taxpayer chooses to submit another OIC at a later date, another application fee is required.

The IRS has made a number of processing changes this year to ensure that processable returns are handled reasonably and responsibly. For example, in situations where taxpayers have made substantially complete responses to additional information requests, the IRS will now attempt an additional contact with the taxpayers to obtain the missing information, prior to returning the OICs. Return reconsideration procedures have been developed and implemented to address situations where the taxpayers could not respond timely due to circumstances beyond their control. As a result, OICs returned following acceptance for processing declined 34 percent in FY 04.

Collectibility Determinations (Reasonable Collection Potential) – Rejection of OICs in Favor of Extended Installment Agreements

In March 1998, the IRS determined that an appropriate period of time for an installment agreement was no longer than five years beyond the CSED. Agreements extending beyond this period are not allowed under our current procedures. If the taxpayer can full pay the tax liability within the parameters of an installment agreement, i.e., the time remaining until the CSED, plus five years, the IRS generally does not accept an OIC.

As noted in the NTA report, the IRS recently analyzed its practice of including the "plus five years" in the analysis of the taxpayer's ability to make future payments and issued direction to discontinue that practice. The IRS believes this change should significantly improve both the accuracy of our RCP calculations and the overall quality of our OIC disposition decisions, and also result in more accepted offers. The percentage of processable offers that were accepted increased by 10 percent last year. The Treasury Inspector General for Tax Administration (TIGTA) also reported positive results regarding the quality of the IRS' case decisions in their recent reviews of the COIC and Field OIC programs.

Calculating Reasonable Collection Potential (RCP) – Deviating From National And Local Standards

National and local standards were developed to promote consistency among the IRS collectors in the amounts routinely allowed for taxpayer expenses. The IRS employees are, however, authorized to deviate from these standards in certain situations.

The IRS reemphasizes this direction to OIC personnel on a regular basis. Earlier this year, the IRS issued additional guidance in the area of reasonable allowances for transportation expenses. During the past year, the IRS has also asked TAS and the American Institute of Certified Public Accountants (AICPA) to provide examples of any unreasonably rigid adherence to the national standards in OIC casework for evaluation. Upon receipt of these examples, the IRS plans to use them to enhance OIC processing.

Calculating RCP – Future Income Projection

The IRS does not agree that the OIC IRM "maintains a rigid income-averaging calculation as the basis for determining future income for sporadic earners, even though other estimates may prove to be more accurate." The IRM (5.8.5.5) allows for alternative methods in appropriate situations:

> In some instances, a future income collateral agreement may be used in lieu of including the estimated value of future income in reasonable collection potential (RCP). When investigating an offer where current or past income does not provide an ability to accurately estimate future income, the use of a future income collateral agreement may provide a better means of calculating an acceptable offer amount. Future income collateral agreements should not be used to enable a taxpayer to submit an offer in a lesser amount than the current or past financial condition dictates. However, if the future is uncertain, but it is reasonably expected that the taxpayer will be receiving a substantial increase in income, it may be appropriate.

The IRS does agree that a few more examples may be helpful regarding this issue, and we will expand the direction accordingly in the next IRM revision.

Calculating RCP – Excluding State Tax Expenses

When determining RCP, payment of current tax obligations is considered a necessary expense and always is allowed. In contrast, delinquent state or local tax obligations are treated like other debts and are deducted from reasonable collection potential only to the extent the state tax obligations take priority over the federal tax debt. Affording special status to state and local taxes as allowable expenses would result in taxpayers with the same collection potential being treated differently based solely on the identities of their other creditors. The IRM encourages offer specialists to consult with Counsel if the relative priorities are unclear.

Effective Tax Administration (ETA) OICs

The "non-hardship" ETA OIC is a situation where no doubt exists that the liability is valid, and payment of the tax would not create economic hardship for the taxpayer. However, due to circumstances of the case, the inequity of requiring the taxpayer to pay the entire liability would be so apparent that the IRS should allow the taxpayer to compromise the tax debt for less than the amount owed. This component of the OIC program was designed to allow the IRS to settle difficult or unusual cases, where other collection alternatives did not seem appropriate. In practice, however, we have received very few cases that meet these criteria.

In FY 03, the IRS centralized the processing of "non-hardship" ETA OICs in one field group to ensure consistency in processing these cases and to facilitate oversight of the process. During the summer of 2004, representatives from the Small Business/Self

Employed (SB/SE) Division, TAS, Counsel and Appeals conducted a joint review of this process. This team reviewed the work papers of all referrals into the ETA group and all OICs worked to completion within the field group during its first year of operation. In its findings, the review team identified opportunities to improve the referral process and document case decisions. However, the team did not identify any cases in which the IRS rejected an offer that should have accepted as a "non-hardship" ETA OIC. As part of their review, the team also concluded that a combination of factors could lead the IRS to accepting such an offer. Based on examples developed by the review team, the IRS expects to issue enhanced guidance in FY 05.

The team's analysis indicates the most problematic component of the "non-hardship" ETA OIC is the requirement that the taxpayer have a clear ability to full pay the tax liability without economic hardship. The examples TAS provided as potential candidates, as well as many of the cases included in the joint review, would actually create the appearance of inequity if the IRS accepted the offers. Routine acceptance of offers in such cases would have a detrimental impact on voluntary compliance.

Generally, experience shows that the inequitable conditions that contribute to the tax delinquencies also tend to create economic hardship on the affected taxpayers. The IRS routinely accepts ETA OICs based on economic hardship, as well as doubt as to collectibility (DATC) OICs involving special circumstances. These OIC categories are worked within all OIC field groups, as well as COIC. Because DATC OICs with special circumstances do not involve situations where the taxpayers can clearly full pay the tax debts, the ETA group does not control them. Rather, the IRS handles them as routine cases, and local management has the authority to approve these case decisions.

The TAS report indicates that the Advocate is including legislative proposals involving the ETA issue. The IRS has not reviewed these proposals for administrability and impact on resources.

Nonprocessability of OICs from Taxpayers in Bankruptcy

In 1998, the IRS decided to exclude from OIC consideration any taxpayer in bankruptcy. The IRS' temporary change of policy in 1999, to again allow some taxpayers in bankruptcy to file OICs, stemmed from an assumption that this reversal in policy was legally mandated. When the Office of Chief Counsel subsequently disagreed with this interpretation of § 525 of the Bankruptcy Code, the IRS reversed its policy to once again exclude taxpayers in bankruptcy from the OIC process. More recently, courts have held that the IRS's policy does not violate § 525.

Taxpayers who file bankruptcy are protected by the automatic stay while their non-exempt assets are liquidated for the benefit of creditors or, in the case of a Chapters 11, 12, or 13, until a payment plan is approved whereby all creditors are paid over a period of time. In exchange for the protections and benefits provided by the Bankruptcy Code, taxpayers must abide by Congressional choices that balance a taxpayer's need for a financial fresh start against the competing concerns of various creditors. By filing bankruptcy, taxpayers make a deliberate choice to follow the Bankruptcy Code's scheme for resolving their debts. Taxpayers who receive a discharge, or otherwise complete a bankruptcy proceeding, are entitled to avail themselves of the OIC process to resolve tax debts that were not discharged or paid through the bankruptcy case.

In those cases where a determination is made that a taxpayer in bankruptcy cannot comply with the requirements of the Bankruptcy Code, the IRS will consider accepting payment of less than is required to be paid under the Bankruptcy Code. Taxpayers filing bankruptcy are required to file schedules of assets and liabilities, a schedule of current income and expenditures, a schedule of executory contracts and unexpired leases, and a statement of financial affairs. In most cases, this information will be sufficient for the local Insolvency office to determine whether it is in the IRS' best interests to agree to receive less than is required to be paid under the Bankruptcy Code.

Combination OICs

The IRS recently completed a pilot project regarding the processing of "combination" OICs where the taxpayers have requested consideration on the basis of both doubt as to collectibility (DATC) and doubt as to liability (DATL). The IRS found that very few DATL OICs actually involve true liability issues, i.e., there are no disagreements that the tax assessments are valid. Generally, these cases involve requests for interest and/or penalty abatements, or other adjustments to the balances due that do not require re-examination of the tax returns.

In order to address these combination OICs in a timely manner, the IRS routinely processes the DATC offers first. If the DATC offer is recommended for rejection, the DATL OIC is forwarded to Examination for consideration. The pilot project confirmed that most of these DATL claims can be processed efficiently by one collection unit in the Brookhaven Campus, and the IRS intends to expand this approach in FY 05 to include all DATL OICs. The relatively rare DATL claims that involve actual liability issues will continue to be forwarded to Examination for consideration.

Appeals

The IRS agrees with the recommendation in the TAS report that systemic identification of errors made on OIC rejections would be beneficial to both SB/SE and Appeals. In fact, Appeals already is proceeding with plans to provide systemically driven feedback reports to all IRS operating divisions. For the OIC program, Appeals already has conducted one informal Offer program review through the Automated Quality Measurement (AQMS) staff and one joint review with the SB/SE Offer program on Appeals' accepted offers. Based on those reviews Appeals has agreed to strengthen its discussion and documentation surrounding our acceptance of offers for two reasons: 1) to enhance guidance and, 2) to ensure Appeals decisions comport with the IRM policies and procedures thus providing credibility to any recommendations we might make for program improvement.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate believes that the IRS has made significant improvements to the OIC program over the last year. Specifically, the IRS should be commended for:

- *Discontinuing the practice of rejecting OICs on the basis that a taxpayer could pay the liability over the CSED plus five years;*
- *Revising its procedures to make its allowances for transportation expenses more reasonable;*
- *Improving the OIC forms and instructions;*
- *Revising procedures so that when taxpayers make substantially complete responses to information requests, they are contacted before their OICs are returned based on a lack of information;*
- *Instituting OIC return reconsideration procedures in cases where taxpayers could not timely respond to information requests due to certain circumstances that were beyond their control;*
- *Reducing the number of OICs returned after acceptance for processing;*
- *Developing guidance regarding when a "non-hardship" ETA offer should be accepted, which may soon be issued;*
- *Allowing for compromise of liabilities via the bankruptcy process in certain limited circumstances; and*
- *Developing plans to allow for systematic feedback between Appeals and SB/SE.*

SB/SE worked closely with TAS in developing many of these improvements and we have enjoyed a good working relationship throughout the year. However, the IRS comments suggest that the OIC program is operating so smoothly that it should not be discussed as one of the IRS' most serious problems. The IRS cites data showing that OIC cases represent less than one percent of IRS collection cases and about two percent of cases worked in TAS. These very statistics suggest that OIC cases make up a disproportionate number of TAS referrals given the small size of the OIC program. Further, many taxpayers do not know about TAS, or do not seek TAS' assistance because they do not believe that TAS can be of help to them.[111] *This is often true since TAS usually cannot change unreasonable policies as applied to a given case and is generally limited to helping the IRS correctly apply such policies or to recommending systemic change.*

[111] *See* the Most Serious Problem entitled *Access to TAS, infra.*

In addition, because collection decisions involved in evaluating OICs are among those that have the greatest potential to result in hardships for taxpayers, the IRS should have little tolerance for errors or inequitable policies in this area. The OIC program is also one of the most visible to taxpayers and has the potential to communicate to the public that the IRS is a reasonable, efficient and fair tax administrator, willing to take the time to work with taxpayers that are trying to fulfill their tax obligations. Instead, as media coverage shows, taxpayers exposed to the OIC process sometimes get the message that the IRS does not care about reason, fairness or true overall efficiency.[112] *This perception may also be damaging to voluntary compliance among the general population. Thus, neither the IRS nor the National Taxpayer Advocate can afford to ignore such an important program.*

The information and analysis provided about programs selected as "most serious problems" are intended to spark debate and to be useful to those seeking to improve them. We hope that this report is received in that spirit. That said, we must specifically address a few of the points reflected in IRS comments regarding effective tax administration (ETA) offers as follows:

- *The IRS states that as part of the joint review of non-hardship ETA OICs, TAS did not identify cases that the IRS should have accepted. As stated previously, the purpose of this review was not to identify specific cases that were decided incorrectly. Because the IRS has no specific criteria that, if present, would result in the acceptance of an OIC based on non-hardship ETA considerations, it would have been impossible to identify cases that were decided incorrectly even if the limited case file excerpts provided to reviewers included all relevant information.*
- *IRS comments state that "experience shows that the inequitable conditions that contribute to the tax delinquencies also tend to create economic hardship on the affected taxpayers. The IRS routinely accepts ETA OICs based on economic hardship…" However, IRS has informed TAS that it does not record such data.*[113] *Thus, we have no way of verifying IRS' statement.*

[112] *See e.g.*, Robert Zarzar, *AICPA Submits Survey Results On Offer In Compromise Program*, 2003 TNT 200-38 (Oct. 15, 2003) (stating: "Based on the concerns expressed by many of our members, we do fear that the IRS employees at the COIC sites might be reducing OIC inventory levels based on implementation of rigid procedures; tight rules regarding what constitutes a "processable" offer and short time frames for submitting updated or missing documents."). A 2003 IRS focus group found that "virtually all the practitioners believe that the Offer in Compromise program is not working." 2003 Nationwide Tax Forum, Focus Groups, *Customer Satisfaction Issues of Practitioners*, Project 01.08.005.03 (consisting of focus groups at six Tax Forum sites with eight to thirteen participants from a wide geographic area, each screened by SB/SE Research staff). See also, Michael J. Knight, *THE IRS OFFER IN COMPROMISE PROGRAM (OR THE 'OH I CAN'T' DEFENSE)*, 2004 TNT 125-29 (June 29, 2004); Brant Goldwyn, *Dispute Resolution: IRS Revises OIC Letters Sent to Taxpayers; Practitioners Advise IRS of OIC Concerns*, 20 DAILY TAX REPORT G-7 (Feb. 2, 2004) (stating that "[b]y not giving additional time or calling practitioners and explaining what's needed, [IRS is] seizing the opportunity to return the offer"). Brant Goldwyn, *Dispute Resolution: TAX COLLECTION: OFFER-IN-COMPROMISE PROGRAM CONTINUES TO BE PROBLEM, IRS AND PRACTITIONERS SAY* 10 DAILY TAX REPORT G-5 (Jan. 15, 2003); Robert E. McKenzie, Statement of Robert McKenzie on behalf of the American Bar Association Section of Taxation IRS Oversight Board Hearing Washington, DC January 27, 2003, *reprinted* in Robert E. McKenzie, *Representation Before the Collection Division of the IRS*, Appendix 13 (April 2004).

[113] Response to TAS Information Request (June 2, 2004).

RECOMMENDATIONS

The National Taxpayer Advocate makes the following recommendations for improving the OIC program:

Reducing Unnecessary OIC Returns

- *The IRS should contact taxpayers and allow a reasonable period of time for them to file delinquent returns before returning OICs on that basis. Because this would delay OIC processing, such periods could be broken out and reported separately from aggregate cycle time measures.*
- *The IRS should make at least two attempts to contact taxpayers before returning any OIC, and otherwise encourage employees to contact taxpayers by telephone or using face-to-face meetings, especially with taxpayers for whom other modes of communication are unlikely to be successful. Calls should be made to taxpayers and their representatives only at times when they are most likely to be available.*
- *The IRS should give employees discretion to determine that an OIC should not be returned in cases where required documentation is missing if they believe that additional communications would likely produce such documentation. If the IRS determines that it cannot accept an OIC based upon insufficient documentation from a cooperative taxpayer, guidance should emphasize that it should be rejected rather than returned so that the taxpayer has an opportunity to appeal the decision.*
- *The IRS should process OICs received from taxpayers in bankruptcy.*[114] *IRS' standards for evaluating such offers should deviate from standard OIC criteria only when there is a clearly articulated reason for such a deviation. For example, it may be reasonable to reject OICs based on doubt as to collectibility in cases where compromise by the IRS would only benefit the taxpayer's other creditors and not the taxpayer.*
- *The IRS should work with taxpayers and practitioners to reduce taxpayer (and IRS employee) burden and make it easier to understand OIC requirements by revising the Form 656 and its accompanying collection information statements. It should also continue its efforts at outreach and education, which we applaud.*
- *The IRS should review the OIC submissions received before and after implementation of the OIC application fee to determine which types of submissions have been deterred by the fee or returned for failure to include it. If the fee has not significantly reduced frivolous submissions and submissions from uncooperative taxpayers or if it presents a significant barrier to taxpayers who are legitimately trying to comply, it may not be worth the burden that it imposes on all taxpayers submitting an OIC. If this is the case, IRS should abolish the fee.*
- *The IRS should revise its Offer in Compromise form (Form 656) to clarify what it means by "doubt as to liability" so that taxpayers know that items such as innocent spouse relief, and*

[114] Yet another court has recently ordered the IRS to process an OIC from a taxpayer in bankruptcy. *See In re Peterson*, 2004 WL 2750095 (Bankr. D. Neb. 2004), adhered to on reconsideration (Nov. 4, 2004).

interest and penalty abatement requests are made on other forms. Revising the Form 656 to make this distinction clear at the outset would help taxpayers avoid wasting the time waiting for the IRS to process the wrong form. However, when the IRS receives such requests on Form 656, it should immediately contact the taxpayer and route the taxpayer's request to the area responsible for processing it.

Reducing Unnecessary Rejections

- *The IRS should research the reasons why OIC rejections have increased and acceptances have declined. It should determine how increased communications could increase acceptance of reasonable offers.*[115]
- *The IRS should revise the current methods of determining Reasonable Collection Potential (RCP):*
  - *It should allow expenses for delinquent state tax payments. Ignoring such expenses is likely to result in minimum offer requirements that leave taxpayers without the ability to meet "basic living expenses," notwithstanding regulatory guidance indicating that offers should not do that, even in cases where IRS would not use involuntary collection tools.*[116] *If IRS believes that other policies produce similar results those policies should also be reexamined.*
  - *The IRS should estimate future income based upon the best estimates available, rather than rigidly adhering to an income-averaging approach. The IRS believes that its policy providing for the use of collateral agreements provides flexibility. However, the IRS is prohibited from accepting an offer for an amount less than would be permitted based on an income-averaging calculation using a collateral agreement.*[117] *Thus, IRS policy allows the use of collateral agreements only in cases where they would benefit the government, not in cases where they would benefit a taxpayer. Many taxpayers would undoubtedly characterize this policy as rigid. Moreover, it ignores the reality faced by taxpayers whose future income will be less than it was in the past.*
- *The IRS should revise the IRM and job aids to more clearly state that the months of future income to be used in determining the offer amount should never extend beyond the statute of limitations expiration date.*

[115] As previously noted, the legislative history of RRA98 states that "[t]he Senate amendment provides that the IRS will adopt a liberal acceptance policy for offers-in-compromise… the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements." H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998). The IRS comments indicate that the percentage of processable offer acceptances have increased in FY 2004. To be clear, however, processable offer rejections have increased by an even greater percentage. Both percentage increases are due to a reduction in the number of offers returned after acceptance for processing, rather than increases in the number of acceptances or rejections. The actual number of acceptances and rejections has declined, as shown on Table 1.19.1, OIC Dispositions, Fiscal Year Comparison, above.

[116] Treas. Reg. § 301.7122-1(c)(2)(i).

[117] IRM 5.8.5.5(6) (Rev. 11-15-2004).

- *The IRS should more clearly communicate the forms of documentation that will be acceptable for purposes of deviating from the expense guidelines, especially in cases where receipts are unlikely to be available or where estimates of future expenditures are involved. However, IRS should be careful not to eliminate an employee's discretion to accept alternative documentation.*
- *Appeals should promptly execute its plan to routinely and systematically identify areas where Appeals and SB/SE have frequent disagreements so that SB/SE can focus its training and guidance efforts accordingly. Appeals should track the reasons for reversing SB/SE's OIC rejections on a computer database so that SB/SE can quickly identify problem areas and take immediate corrective action. This feedback loop should not be used to eliminate Appeals' ability to reach common sense outcomes, which may sometimes be inconsistent with IRM provisions.*
- *The IRS should evaluate ETA offers and doubt as to collectibility offers with special circumstances using the analysis described in the Key Legislative Proposal entitled Offer In Compromise: Effective Tax Administration in section two of this report. Similarly, the bases for offers submitted on more than one basis (combination offers) should be analyzed in the order requested by the taxpayer, as provide in the legislative proposal.*

Cycle time and Quality Measures

- *The IRS should survey taxpayers and practitioners who submit OICs to determine how to best to improve the OIC program.*
- *The IRS should measure cycle time by breaking it out by type of disposition (e.g., return, acceptance, rejection, withdrawal or termination). Its cycle time measures should also systemically track the time wasted by the IRS and taxpayers when the IRS returns an OIC that is later resubmitted.*
- *The IRS should evaluate whether the new Embedded Quality Measurement System (EQMS) provides the proper incentives to employees and enables it to rapidly identify specific systemic problems that could be addressed through training or guidance. IRS should also determine ways of converting CQMS quality measures into EQMS measures so that it can track recent quality trends. Quality trends may be more useful than static measures at determining whether systemic changes are effective.*[118]

[118] IRS comments indicate that TIGTA recently reported positive results regarding the quality of IRS' OIC case decisions. We note that the quality component of the TIGTA's review involved an analysis of 100 field offers closed in FY 2003 (50 accepted and 50 rejected but not appealed) and found that 37 involved errors in financial analysis, 12 of which affected the outcomes. *See* Treasury Inspector General for Tax Administration, *Improvements Are Needed in the Timeliness and Accuracy of Offers in Compromise Processed by Field Offer Groups*, 2005-30-013, 12-14 (December 2004). The results were likely affected by the fact that TIGTA did not include rejected OICs that were appealed. *Id*. at Appendix I. Moreover, the purpose of the report was not to evaluate overall OIC quality. Because the report used a judgmental sample (rather than a random sample), the results were not statistically projected to the field component of the OIC program. *Id*. The IRS response indicates that IRS believes the errors may be attributable to unrealistic IRS policies in calculating reasonable collection potential. *Id*. at 34. As noted above, the NTA agrees that such unrealistic policies should be revised without

PROBLEM TOPIC E-20

MOST SERIOUS PROBLEM: TAXPAYER RIGHTS TRAINING IN A COMPLEX AND CHANGING TAX ENVIRONMENT

RESPONSIBLE OFFICIALS

Henry O. Lamar, Jr., Commissioner, Wage and Investment Division
Kevin M. Brown, Commissioner, Small Business/Self-Employed Division
Steve Miller, Commissioner, Tax Exempt and Government Entities Division
Debbie Nolan, Commissioner, Large and Medium Size Business Division
David B. Robison, Chief, Appeals

DEFINITION OF THE PROBLEM

The IRS has announced its intention to substantially increase its enforcement presence and replenish the ranks of enforcement personnel. This strategy requires an equally strong focus on producing IRS professionals who are well schooled in both the technical and behavioral aspects of tax administration. It presents an especially daunting challenge in an era of budget containment and increasing legal complexity. The National Taxpayer Advocate and several oversight bodies have expressed concern that current IRS training programs may not provide sufficient emphasis upon:

- The role and authority of the Taxpayer Advocate Service (TAS) in resolving problems for taxpayers and in protecting their rights;[1]
- The duty to promote equitable treatment of similarly situated taxpayers in their dealings with IRS;[2]
- The need to explicate the principles of flexibility and empathy for taxpayers and the critical thinking skills that produce sound judgment; and,
- The quality and depth of technical training.[3]

ANALYSIS OF PROBLEM

The IRS Oversight Board recently reaffirmed the criticality of training to human capital strategy, and observed of the IRS workforce that "it must be carefully selected, trained, and given the skills and tools it needs to meet the demands of tax administration in the 21st century."[4] Anecdotal information received from stakeholders and IRS employees by the oversight board suggests that, "the lack of adequate training was a dominant issue. Stakeholders described an expanding training gap at the IRS, where employees often lack the expertise and skill to handle difficult, complex, or problem cases."[5]

[1] IRC § 7803(c)(2); Russell Marketing Research, *Findings from Task 149 – The Taxpayer Advocate Service Research Program*, Sept. 2002, 21. This study determined that at any one time 1.5 million taxpayers meet the "significant hardship" test, thereby qualifying for TAS assistance. Although 43 percent feel intimidated by the IRS and are not likely to contact the IRS or TAS for help, only a small number of the remaining 57 percent ever make it to TAS for assistance, suggesting that IRS employees may not be properly educated on TAS significant hardship and referral criteria.

[2] IRC § 7803(c)(2).

[3] IRS Oversight Board, *2004 Annual Report*, 22.

[4] *Id.* at 21.

[5] *Id.* at 22-23.

The IRS has modified its training philosophy over the past decade, replacing the more resource intensive "Corporate Education" model with a scaled down, technology-based "just in time" approach, which is administered primarily by the functional Operating Divisions. Economic factors have dictated that fewer training sessions are conducted in the traditional classroom environment. Experts acknowledge that if properly designed, both distance and classroom instruction can be equally effective. The issue, however, is how to leverage technology to replicate the environment fostered by face-to-face interaction.[6] This presents a special challenge to the IRS since many of the most useful techniques for promoting the development of critical thinking skills, judgment, and in-depth discussion of issues are better suited to an in-person approach and require considerable interaction and idea sharing. Continuing Professional Education (CPE) for field professionals has been curtailed or, on occasion, eliminated due to fiscal constraints. Since experienced employees also need to burnish both technical and interpersonal skills, this unevenness is a cause for concern.

Obviously, the training needs of an organization of more than 100,000 employees are diverse. While IRS e-Learning has been recognized for providing cost effective instruction, no measurement of its impact on enhancing interactive skills for field professionals has yet been established. The Service plans to convert most current training to an e-Learning format by fiscal year 2007.[7] The Office of the Taxpayer Advocate has committed to an ongoing review of compliance training, with special emphasis on instruction provided to both new hires and veteran employees on the following topics:

- Application of judgment to complex tax issues;
- Knowledge and understanding of TAS; and
- Aggressive protection of taxpayers' rights through open communication and creative problem solving.

Methodology of Review

The volume of IRS training classes is enormous. The Treasury Inspector General for Tax Administration (TIGTA) identified 4,713 courses in its review of training, although the IRS conducted only 2,606 of them in FY 2002.[8] To narrow the scope of its review, TAS surveyed compliance-related training for the following professions: Revenue Officer, Revenue Agent, Appeals Officer, Taxpayer Resolution Representative, and Customer Service Representative. We also reviewed specific training related to issues with high

---

6 Carol A. Twigg, "Innovations in Online Learning: Moving beyond No Significant Difference," Center for Academic Transformation at Rensselaer Polytechnic Institute (2001), available at http://www.center.rpi.edu/PewSym/.

7 Stephen Losey, "IRS eLearning Saves Training Dollars," Federal Times.com, May 3, 2004, available at http://federaltimes.com/index.

8 Treasury Inspector General for Tax Administration (TIGTA), *Information on Employee Training Is Not Adequate to Determine Training Cost or Effectiveness*, Reference No. 2003-10-212, 4 (Sept. 2003).

impact on taxpayer rights, such as offers in compromise. Computer-related courses were excluded, as well as those classes dealing with internal processes and highly technical, small impact tax law issues. After consulting the IRS' catalogue of courses, approximately 100 were selected for scrutiny.

ANALYSIS OF TRAINING CONCERNING TAXPAYER ADVOCATE SERVICE

The IRS training materials addressing TAS, its Congressionally mandated mission, and the obligations of IRS employees to refer cases to TAS are inadequate. Further, the almost total absence of secondary material that integrates TAS into the compliance employee's routine duties is puzzling, and seemingly inconsistent with the "spirit" of several Congressional mandates. The review considered the following issues:

- *Referral Criteria:* Did material clearly describe the criteria for referring Taxpayers to TAS?
- *Hardship:* Was an explicit definition of what constitutes a significant hardship provided?
- *TAS Procedures:* Were the requirements imposed by Taxpayer Assistance Orders and Operations Assistance Requests (OARS) explained?
- *TAS' Authority:* Was the scope of TAS' authority discussed?
- *Service Level Agreements:* Were the provisions of the appropriate Service Level Agreement with TAS adequately described and explained?[9]

Findings of Training Review

The majority of compliance training material does not adequately address the role of TAS or how employees are expected to interact with TAS. Indeed, most courses lack any meaningful discussion of TAS and its impact upon taxpayers' rights or examples of TAS referrals. Trainees would find it particularly difficult to identify at which juncture in the compliance process a referral to TAS would be appropriate. Thus, taxpayers are potentially deprived of an important safeguard.

This deficiency is amply illustrated by the following IRS training course. *SB/SE Compliance Services Operations-Return Delinquency*, an entry-level class, is designed to familiarize the employee with the overall IRS structure and operations.[10] The material discusses the four compliance divisions, but excludes both TAS and Appeals. Both functions are independent within IRS and protect taxpayers' rights. It is imperative that employees understand this from the very beginning of their IRS careers, and avoid the type of insular thinking that can otherwise result. TAS is mentioned peripherally in the *Appeals Basic on-the job training*, with the following reference:

[9] Service Level Agreements are written contracts between TAS, the IRS operating divisions, the Office of Appeals, and Criminal Investigation that outline how TAS interacts with various IRS operations, and how each organization should work with TAS on taxpayer problems.

[10] IRS, *SBSE Compliance Services Collection Operations – Return Delinquency*, Training Publication 5732-102 (Rev. Sept. 2003), A -1-10.

> "Cases that are already in Appeals may be the subject of a TAS contact. Usually the taxpayer is asserting that there has been a mistake made in the processing of his case. Sometimes, TAS requests that the case be expedited through the Appeals process with a TAS assistance request."[11]

This reference does little to train the Appeals employee about TAS criteria, processing Operations Assistance Requests (OARS), or responsibilities under the Service Level Agreements, and it gives a false impression that TAS has minimal influence and involvement in TAS' appeals inventory. Similarly, although *Offers in Compromise for Offer Specialists and Examiners* does include information indicating that TAS is empowered to inquire about the status of an offer and may represent taxpayers during processing, it gives no instructions about proper procedures once TAS is involved, nor does it explain the breadth of TAS' authority.[12] In the *Employee Plans Examination Phase II* training there is an abbreviated reference to TAS in the discussion of issue resolution. It states, "Taxpayers should know that they can speak with the manager and avail themselves of other options such as …the Taxpayer Advocate if they encounter problems."[13]

The examples previously cited are characteristic of the treatment of TAS in most of the compliance training materials. A notable exception can be found in the materials entitled *Introduction to Core Topics*.[14] This cross-functional course for all new IRS employees contains a specific lesson on *Help with Unresolved Tax Problems*, which includes a substantive overview and stated objectives of TAS. The syllabus provides for exercises to strengthen the students' knowledge by requiring them to identify which hypothetical situations qualify for TAS assistance. TAS toll free numbers are listed, and the Instructor Guide includes supplemental training material on the topic.[15]

The IRS can and must replicate this approach in its compliance and customer service training material. Research has affirmed that application of complex material and development of critical thinking skills are best transmitted through experiential learning.[16] Many of the conflicts that arise between TAS and IRS employees are attributable to misinformation about the nature and authorities of TAS. We believe it is imperative that the IRS institutionalize its approach to training newly hired employees and reinforcing the message its experienced public contact employees receive about TAS.

[11] IRS, *Appeals Basic On-the-Job Training*, Training Publication 6102-002 (Rev. Aug. 2003) 4-10.

[12] IRS, *Offers in Compromise for Offer Specialists and Examiners*, Training Publication 2242-102 (Rev. Jan. 2000).

[13] IRS, *Employee Plans Phase II Examinations*, Training Publication 4334-202 (Rev. March 2004), chapter 12, 32.

[14] IRS, *Introduction to Core Topics*, Training Publication 6602-102 (Rev. Aug. 2004).

[15] IRS, *Introduction to Core Topics (Instructor Guide)*, Training Publication 6602-101 (Rev. Aug. 2004) 9. The Instructor Guide directs the instructor to obtain IRS Document 11189, *Taxpayer Advocate Service – Training Guide for Internal Revenue Service Employees* (Rev. Oct. 2002), and use it as a training aid.

[16] For a full discussion of this concept see David A. Kolb, "Experiential Learning: Experience as the Source of Learning and Development", Prentice Hall, Inc. (1984), Englewood Cliffs, New Jersey; see also David Lazear, "Seven Ways of Knowing: Teaching for Multiple Intelligences", Skylight Publishing, Inc. (1991), Palatine, Illinois.

Review of Taxpayer Rights Training

In her Fiscal Year 2005 Objectives Report to Congress, the National Taxpayer Advocate stated that, "aggressive enforcement action requires aggressive protection of taxpayer rights. Otherwise, the system fails."[17] The IRS must incorporate this philosophy into its training materials and resulting work processes by combining a thorough understanding and application of taxpayer rights with an in-depth knowledge of the enforcement process. The following information was considered to determine how taxpayer rights were treated in IRS training:

- Did the course material include a listing of taxpayer rights similar to those listed in Publication 1, *Your Rights as a Taxpayer?*
- Were the identification and consideration of taxpayer rights stated as course objectives?
- Did the course material routinely incorporate the consideration of taxpayer rights into the lesson plan?
- Did the course material identify all applicable statutory or due process rights of taxpayers and include an explanation of the role each of these provisions play in tax administration and the fair treatment of taxpayers?

Review Findings

Most of the recently revised IRS training material (2001-present) includes a listing of taxpayer rights at the beginning of the course, generally presented in conjunction with the IRS Mission Statement and the Code of Ethics. Several courses contain a separate module delineating taxpayer rights, but they seldom incorporate the concept of taxpayer rights into the case studies or require that students consider the impact on taxpayer rights when discussing enforcement options.

For example, SB/SE training for new Revenue Agents and Tax Compliance Officers has a section entitled *Protecting Taxpayer Rights in the Examination Process.*[18] The section discusses a variety of subjects including appeal rights, confidentiality, third-party contacts, innocent spouse relief, interest abatement, separate notices for joint filers, and privacy safeguards. While it does a good job of addressing these important topics, this section stands alone and is not woven into the fabric of the other lessons on enforcement actions and processes. Presenting taxpayer rights in its own section of training is an excellent way to introduce the issue, but integrating it into the text and examples of other sections encourages dialogue and reinforces the message. Arguably, if the duty to affirmatively consider taxpayer rights is seamlessly incorporated into the text of training materials, IRS employ-

[17] National Taxpayer Advocate, *FY 2005 Objectives Report to Congress*, Publication 4054 (Rev. June 2004), 1.

[18] IRS, *Revenue Examiner Training Unit I Instructor Guide*, Training Publication 5609-101 (Rev. June 2002), B-1-19 B-1-23.

ees may have an added dimension to consider as they perform their duties and taxpayers will have meaningful protection instead of mere lip service.

Our review also found positive examples of training materials that achieve the balance between appropriate enforcement actions and consideration of taxpayer rights. In the *Penalty Abatement for Compliance Employees* training, emphasis is placed upon issues impacting taxpayer rights throughout the course, rather than exclusively in a single chapter.[19] Chapter one reminds employees of an additional requirement to secure supervisory approval for asserting "non-automatic" penalties as enacted in the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).[20] The materials also emphasize laws and regulations to which employees must adhere when making penalty determinations. Finally, employees are cautioned not to immediately deny the taxpayer's request because of insufficient information, but to allow the taxpayer the opportunity to supplement the information.[21]

The *Innocent Spouse Determinations Training* demonstrates an especially positive approach.[22] By providing frequent examples and reinforcing the need to consider taxpayer rights, this course illustrates that employees can be taught the components of compliance jobs while considering individual circumstances.[23]

The Instructor Guide for the course also reminds those summarizing the lessons in six of nine chapters that the Congressional mandate requires the IRS to

- Inform taxpayers of the innocent spouse process;
- Inform taxpayers of their rights; and
- Provide taxpayers the greatest benefit possible under the law.[24]

These strictures are appropriate for most IRS enforcement procedures.

---

[19] IRS, *Penalty Abatement for Compliance Employees – CPE for Revenue Agents, Tax Compliance Officers, Tax Auditors, and Revenue Officers*, Training Publication 3410-002 (Rev. June 2002).

[20] IRC § 6751(b). This provision became effective after June 30, 2001, and requires written management approval before any penalties can be assessed. The intent was that a requirement of supervisory approval would deter IRS employees from artificially inflating assessed penalties to meet any collection-based performance goals. This provision does not apply to additions to tax for failure to file or pay under IRC § 6651, failure to pay estimated tax under IRC § 6654 or IRC § 6655, or any other automatic computer generated penalty.

[21] IRS, *Penalty Abatement for Compliance Employees – CPE for Revenue Agents, Tax Compliance Officers, Tax Auditors, and Revenue Officers*, Training Publication 3410-002 (Rev. June 2002).

[22] IRS, *Innocent Spouse Determinations*, Training Document 8534-102 (Rev. Nov. 2003).

[23] Another positive example of training that focuses on individual circumstances involves processing innocent spouse claims of domestic abuse victims. Although this course was not reviewed as part of our sample, it is a good example of training material that reinforces taxpayer rights. This course is especially notable because it was developed in cooperation with external stakeholder groups. IRS, *Domestic Abuse and Its Relevance to Innocent Spouse Claim Processing*, Training Document 5701-002 (Rev. May 2001).

[24] IRS, *Innocent Spouse Determinations*, Training Document 8534-101 (Rev. Nov. 2003).

Review of Training in Critical Thinking and Sound Judgment

The following questions were considered to determine whether training materials promoted or enhanced sound judgment in participants:

- Did the text contain a variety of potential solutions that required students to discern the best approach?
- Did the training material present a range of alternatives that might achieve compliance goals while being less intrusive to taxpayers?
- Were case studies coupled with directed discussion used to stimulate class involvement?

The analysis found that a number of IRS compliance modules do a good job of enhancing judgment on technical issues. This was especially evident in training on the application of tax law and procedures.

The *Offers in Compromise* training amply illustrates the potential to encourage critical thinking skills.[25] The IRS has established fixed standards that are used to determine allowable expenses. Since employees may deviate from this standard with supervisory approval, it is an important topic for discussion. The course material includes case studies and group discussion. We encourage the addition of more complex material that explores hardship criteria, and how that may differ in each situation. As noted by educators specializing in adult learning, "…knowledge in this century involves more than just remembering things. It is remembering plus learning to transform information."[26] This approach will promote a cognitive process that allows employees to learn how to effectively interview and otherwise obtain information from taxpayers, better document their recommendations, and explain the issues cogently to their immediate supervisors. It may also allay some of the concern recently expressed by the chair and ranking member of the Senate Finance Committee relative to the informed use of judgment in OIC cases.[27]

Occasionally, compliance training material may inhibit judgment by omission. For instance, the *Revenue Officer Basic Training* (unit 4) acknowledges that "IRM 5.12.1.16 requires that you exercise sound judgment in deciding whether or not a Notice of Federal Tax Lien (NFTL) should be filed. You must balance the taxpayer's interest with that of the government."[28] However, our findings indicate that the course material is less helpful

[25] IRS, *Offers in Compromise for Offer Specialists and Examiners*, Training Publication 2242-102 (Rev. Jan. 2000) C-3-12.

[26] Coleen L. Geraghty, "Learning (and Teaching) in the Technological Age", San Diego State University Press (Feb. 2, 2004), available at http://www.sdsuniverse.info.

[27] Letter from Senate Finance Committee Chairman Charles Grassley and ranking member Max Baucus to John Snow, Secretary of the Treasury, 2004 TNT 173-54, September 2, 2004. For a detailed discussion of this and other issues in the OIC program, see the section of this report entitled Most Serious Problem: Compliance in a Complex & Changing Tax Environment; Offers In Compromise.

[28] IRS, *Revenue Officer Basic Training, Unit 4, Module A, Priority of the Federal Tax Lien*, Training Publication 2234-001 (Rev. Feb. 2001) A-8.

in guiding Revenue Officers to balance those considerations and make an informed decision. There are no scenarios or detailed examples outlining when filing a NFTL is not advisable. A vigorous discussion of the balancing test may both foster judgment in trainees and reinforce the concept of taxpayer rights.

Some training courses do a good job of enhancing the ability to exercise independent judgment. For example:

- *Penalty Training for Appeals Technical Employees* helps students enhance critical thinking skills when asserting or abating penalties.[29] The course contains case studies, which are used to isolate which factors determine the proper course of action. By using detailed scenarios and discussing alternatives, students learn how to exercise informed judgment based on the individual facts and circumstances of cases. Similarly, the introductory Appeals training course covers Rules of Evidence, Factual and Legal Hazards of Litigation, and how to determine acceptable settlement ranges.[30] These subjects enhance critical thinking skills and emphasize the nuances present in most actual cases.
- *Advanced Technical Training for Revenue Officers* illustrates how effectively the IRS can use scenarios and Socratic teaching methods[31] to build judgment.[32] The course consists solely of six case studies and has a facilitator, rather than an instructor, to guide the class through research and questions in exploring collection options on complex cases.
- The *Penalty Abatement for Compliance Employees* CPE course continually reinforces the need to exercise independent judgment. Students are advised in Lesson 1 and throughout the course to consider whether taxpayers can avoid the penalties by providing reasonable cause explanations.[33] In addition, the language of the course promotes more introspection. Employees are encouraged to evaluate, analyze and consider all facts and circumstances.
- *The Inventory and Cost of Goods Sold Exam Techniques* course instructs students to glean information from judicial decisions and use it to identify issues, analyze facts, and apply rules of law and case precedents in their examinations.[34] Companion exercises permit students to apply the information learned in each area.

[29] IRS, *Penalty Training for Appeals Technical Employees*, Training Publication 6105-002 (Rev. Sept. 2003).

[30] IRS, *Appeals Basic Training*, Training Publication 6137-002 (Rev. June 2003).

[31] The Socratic method of teaching focuses on giving students probing questions, not answers, to foster critical thinking. By following up answers with questions that advance the discussion, the Socratic method forces a class to think in a disciplined, intellectually responsible manner.

[32] IRS, *Advanced Technical Training for Revenue Officers*, Training Publication 2252-002 (Rev. June 1995).

[33] IRS, *Penalty Abatement for Compliance Employees – CPE for Revenue Agents, Tax Compliance Officers, Tax Auditors, and Revenue Officers*, Training Publication 3410-002 (Rev. June 2002).

[34] IRS, *Continued Professional Education for Revenue Agents – Inventory and Cost of Goods Sold Examination Techniques, Training Publication 5723-212* (Rev. June 2002).

These examples illustrate how adept the IRS can be at using interactive techniques that promote students' comprehension of technical material. Approximately 25 percent of the courses reviewed used case studies, directed discussion, or other interactive techniques to elicit questions and test for understanding of the material. As more IRS compliance functions are redirected to campus (processing center) locations, it is essential that training for these employees be structured in a similar fashion. A culture of "rote responses" or "template solutions" does not serve the tax system or the taxpayers who use it.

Items for Further Review

By incorporating an aggressive concern for taxpayer rights, the role of TAS, and sound judgment into the curriculum, the IRS can satisfy both internal needs and external scrutiny. The National Taxpayer Advocate firmly endorses the concept of providing employees with superior technical training and would welcome the opportunity to partner with the IRS over the next year to further explore the following aspects of its training program:

Effectiveness of the training. Is the IRS able to assess the effectiveness of its training classes? Can pre- and post-tests, plus subsequent feedback, determine the return on investment?

Consistency of Outcome. As a result of training provided, can we ascertain that similarly situated taxpayers receive same treatment? (The respective quality management staffs of each division must undertake a sample review for this element.)

Ratio and quality of on the job instructors to the number of new hires. This will determine if adequate coaching and transfer of knowledge are being provided.

Appropriateness of training time to job complexity. We will review equivalent positions in both government and the private sector to gauge how IRS compares in this area.

Delivery Vehicles. Is the IRS using the most effective means as well as the most efficient method for training its employees in critical areas?

IRS COMMENTS

The IRS agrees that it is imperative that employees are trained on the role and authority of the Taxpayer Advocate Service (TAS) and the importance of protecting taxpayer rights. With the support of specialized Learning and Education components, we strive to develop and deliver high quality technical training to ensure that employees have the knowledge and skills needed to perform their jobs effectively. The IRS' goal is to provide all employees with superior training needed to successfully perform their jobs and to use a variety of training delivery methods to ensure effective and efficient training deployment. We will continue to review our technical training to ensure that courses, regardless of delivery method, incorporate an appropriate emphasis on taxpayer rights and the role of

TAS, and foster the development of sound judgment. The IRS operating divisions welcome the opportunity to partner with the Taxpayer Advocate Service to further strengthen the IRS's training program.

Effectiveness of Training

The IRS uses the Training Development Quality Assurance System (TDQAS) to guide training developers through six phases of course development: Assessment, Analysis, Design, Development, Implementation, and Evaluation.

Course development project managers will be briefed on the training concerns noted in the TAS report and will incorporate into training materials, as appropriate, additional information about the role and responsibilities of TAS and the importance of protecting taxpayer rights. In addition, IRS project managers will be encouraged to engage TAS personnel in appropriate phases of the TDQAS process.

During the "evaluation" phase of TDQAS, learner reaction and achievement are measured, as well as job performance and organizational impact. Four levels of evaluation, commonly known as the Kilpatrick Model, are used by the IRS to assess the effectiveness of training. Level I evaluation measures reactions and attitudes of trainees and determines if methods and modes of teaching were appropriate. Level II evaluation determines whether trainees learned the skills or acquired the knowledge as a result of training. Level III evaluation determines whether trainees used the skills and knowledge on the job. Level IV evaluation determines whether organizational outcomes were influenced or accomplished by the training program.

Results of the evaluation phase are incorporated into the next course development cycle or used to identify near-term course corrections/improvements. Level I and Level II evaluation methods are routinely employed for most IRS courses. Level III and Level IV evaluation methods are used more selectively. In fiscal year 2005, IRS will increase its efforts to conduct Level III and Level IV evaluations. Working with the IRS Human Capital Organization, each IRS functional Operating Division will target specific courses in critical occupations for Level III and Level IV analysis.

Consistency of Outcomes

The IRS is in the process of reengineering aspects of core curricula from a "knowledge-based" platform to one that is "performance-based."[35] Existing training is being examined to ensure that the core training enables employees to attain critical job-related technical and procedural competencies.

[35] "Knowledge-based" refers to the classroom, theoretical approach as opposed to the "performance-based approach" that ensures the application of knowledge to the job. It is important for employees to understand the theory and learn the law, case procedures, computer applications, etc., as well as understanding and learning how to apply that knowledge to real-life situations and everyday activities. The performance-based approach aims to train employees to carry out their work and understand the reasons for their actions.

Since the Servicewide reorganization in October 2000, the Operating Divisions have aggressively standardized their training curricula on a national basis, eliminating regional and local training variations. Standardized training for new hires helps to ensure consistency of outcomes for similarly situated taxpayers.

Some of the divisions have instituted Embedded Quality Review Systems to provide for the early identification of deficiencies. In addition, headquarters analysts conduct program reviews during the year and those reviews help to identify weaknesses in technical or program procedures.

Ratio and Quality of On-the-Job Instructors

Structured on-the-job training programs and qualified on-the-job instructors are used to ensure that new hires receive quality and timely guidance and that knowledge is effectively transferred from experienced personnel. On-the-job training programs include numerous training and procedural workshops that are taught by Subject Matter Experts in the job setting. These workshops enable new hires to work with "live" cases and "real situations" under the guidance of on-the-job instructors.

Appropriate on-the-job instructor ratios are determined by analyzing the work performed by new hires and through consultation with specialized Learning and Education staff. Although general guidelines are established for new hire to on-the-job instructor ratios (typically from 3:1 to 5:1), these ratios are frequently adjusted to account for job complexity and requirements, degree of support needed and the geographical dispersion of the new hires.[36] The on-the-job training period can approach a one-year time period for some highly technical or procedurally intensive occupations. During the on-the-job training periods, new hires work cases under the supervision of on-the-job instructors/Subject Matter Experts and receive regular feedback and counseling.

Information regarding the effectiveness of on-the-job training is frequently gathered during the Level III evaluation process, which is typically conducted more than six months after training activities are conducted. This information, along with additional interviews, focus group discussions with new hires and on-the-job instructors, and managerial feedback, is used to revise and improve on-the-job training programs.

Appropriateness of Training Time to Job Complexity

IRS frequently conducts benchmark studies of accounting and business firms to determine the nature and degree of training afforded to their professional work force. In addition, we have effectively recruited employees from the private sector and in several instances have engaged them in IRS course development activities.

[36] The Large and Mid-Size Business (LMSB) division is currently testing an 8:1 ratio in a few locations under strict conditions; the normal ratio has been 4:1. This test is the result of a management directive and no changes will be made until the test is complete.

IRS courses are developed using the TDQAS model and we strive to ensure that training is designed and tailored to achieve the attainment of the competencies associated with specific jobs. The issue of job complexity is carefully analyzed to determine not only the proper amount of training time, but also the best training types (formal training, on-the-job training, continuing professional education, just-in-time, etc.) and the best delivery methods (instructor led training, technology enabled learning, etc.) to achieve the desired results. Several of the divisions are seeking to create a "continuous learning" environment, enabling employees to engage in learning activities in a transparent fashion, paralleling the demands of their job duties and responsibilities. While there are many effective training types and delivery methods, the best measures of training effectiveness are formalized evaluation methods and job performance.

Delivery Vehicles

There is no "one size fits all" solution when it comes to training delivery. At this time, the vast majority of new hire formal training continues to be delivered in an instructor led classroom-based training fashion.

With the emergence of new technologies, a variety of technology enabled learning methods are starting to be employed with increased frequency. When looking at entire training programs for particular occupations, the IRS is moving toward "blended" training approaches. That is, a mixture of delivery methods may be used during comprehensive training programs including instructor led classroom delivery, web-based training, interactive video technology, video or DVD media, web-based conferencing, etc. During the past year, Learning and Education professionals have been participating in "Learning Solutions" workshops to better enable them to appropriately match learning activities with the best delivery methods.

TAXPAYER ADVOCATE SERVICE COMMENTS

The National Taxpayer Advocate supports the IRS efforts to deliver training that is effective and efficient using a variety of delivery methods and is encouraged by the IRS' decision to increase aspects of its training course evaluations to determine whether trainees transfer the knowledge obtained in training to job related activities (Level III evaluation) and whether the training received affected organizational business results (Level IV evaluations). She also appreciates the invitation to partner with the IRS Operating Divisions and functions in strengthening training curriculum to ensure IRS employees have a working knowledge of the Taxpayer Advocate Service and understand the importance of, and their obligation to protect, taxpayer rights.

However, the concept of "continuous learning" raises some concerns for the National Taxpayer Advocate. While this may be an effective tool for providing some highly specific technical training, it should not supplant broad, in-depth foundational learning. The IRS should not be superficially training employees and letting them learn details as issues arise in cases; in essence, using taxpayers as "case studies".

Much of the current IRS training is ineffective in conveying the importance of taxpayer rights or the existence and mission of the Taxpayer Advocate Service. It is imperative the IRS promptly update its training not only to incorporate these aspects, but also to structure the training to teach and encourage critical thinking skills. To accomplish this, the National Taxpayer Advocate makes the following recommendations:

- *The IRS must revise the content, placement, and techniques of training employees about the Taxpayer Advocate Service.*
- *Course offerings for both newly selected and experienced employees must include serious discussions of the mission, referral criteria, scope of authority, and statutory mandates of TAS.*
- *Requirements under the Service Level Agreements between TAS and operating divisions must be described and explained.*
- *IRS should routinely integrate questions concerning the possible involvement of TAS into the case studies and scenarios of each compliance module. Employees should be taught that making appropriate referrals to TAS is their responsibility as IRS employees.*
- *Consideration of taxpayer rights must be integrated into each case study or scenario or directed discussion to emphasize to employees that it is a firm expectation. Practitioners and other professionals should be invited to teach certain aspects of technical issues in order to provide IRS employees with other views of issues in context.*
- *Training material, through case studies and examples, must also encourage employees to identify and evaluate alternatives that achieve compliance objectives without unnecessarily burdening taxpayers.*

- *Modules should identify and provide an overview of all applicable statutory or due process rights of taxpayers as they pertain to the IRS procedures being taught.*
- *IRS should ensure that all training courses include among their course objectives a goal of encouraging critical thinking skills and enhancing the judgment employees will use when discharging their duties.*
- *The IRS must maintain an appropriate ratio of on-the-job instructors to new hires in all situations. While LMSB has every right to test an 8:1 ratio, the standard ratio of between 3:1 and 5:1 should not change unless the test makes clear that the higher number does not impair the learning process.*
- *IRS should ensure that an external panel of stakeholders, education authorities, and tax professionals periodically evaluates its training curriculum, to assess how well the issues of taxpayer rights, the Taxpayer Advocate Service, critical thinking skills, and judgment are integrated into the content of compliance training. The Taxpayer Advocacy Panel (TAP), the Low Income Taxpayer Clinic (LITC) program, and the Internal Revenue Service Advisory Council (IRSAC) should all be part of this evaluation, with members rotating on an annual or biannual basis.*

PROBLEM

TOPIC E-21 MOST SERIOUS PROBLEM: ACCESS TO THE TAXPAYER ADVOCATE SERVICE

PROBLEMS

IRS RESPONSIBLE OFFICIALS

Henry O. Lamar, Jr., Commissioner, Wage & Investment Division
Kevin M. Brown, Commissioner, Small Business/Self-Employed Division
Steve Miller, Commissioner, Tax Exempt/Government Entities Division
Deborah Nolan, Commissioner, Large and Mid-sized Business Division
David B. Robison, Chief, Appeals
Nancy Jardini, Chief, Criminal Investigation

DEFINITION OF THE PROBLEM

Congress created the Office of the Taxpayer Advocate to (1) assist taxpayers in solving their problems with the Internal Revenue Service, and (2) identify administrative and legislative changes that mitigate or prevent those problems.[1] The Case Advocacy function of the Taxpayer Advocate Service (TAS) assists taxpayers with their specific problems, while the Office of Systemic Advocacy addresses broad-based problems that affect groups of taxpayers.

Since its inception in March 2000, TAS' caseload has consistently and significantly dropped. While this reduction in cases may be viewed as a positive development, independent market research indicates that TAS is reaching about four percent of the approximately 5.25 million taxpayers currently eligible for TAS assistance.[2] Most disturbing, this research found that only a small percentage of taxpayers eligible for TAS' services had ever heard of TAS.[3]

Without adequate funding of TAS' outreach activities, adequate training of IRS employees about TAS, and management support for employees referring eligible taxpayers to TAS, the Taxpayer Advocate Service will continue to be the best kept secret in the IRS. As a consequence, taxpayers are harmed because they do not receive the help they need to resolve their IRS problems.

[1] Congress originally codified the administrative "tax ombudsman" in the Taxpayer Bill of Rights (TBOR 1), included in the Technical and Miscellaneous Revenue Act of 1988. Over the years, Congress strengthened this position to ensure that taxpayers have someone to go to for help with their tax problems. For a more detailed discussion of the evolution of the Office of the Taxpayer Advocate, *see* National Taxpayer Advocate, *Fiscal Year 2005 Objectives*, Pub. 4054 (Rev 8-2004), Appendix I; National Taxpayer Advocate, *Annual Report to Congress*, Pub. 2104 (Rev. 12-2002), 200.

[2] Russell Marketing Research conducted a study for TAS, *Findings From Task 149 – The Taxpayer Advocate Service Research Program: With a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3*, (July 2002), and estimated that between 3.9 million and 6.6 million taxpayers were eligible for TAS' services. We are using the midpoint of the range, 5.25 million, in this discussion.

[3] The Russell Marketing study stated: "As hypothesized in Phase 1 of the study lack of awareness of TAS is clearly a part of the underutilization problem, with only three percent who met the TAS qualifying criteria for being Underserved aware of TAS voluntarily and with only 16 percent aware after prompting." Russell Marketing Research, *Findings From Task 149 – The Taxpayer Advocate Service Research Program: With a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3*, (July 2002), at 7.

ANALYSIS OF PROBLEM

Mission of the Taxpayer Advocate Service

Internal Revenue Code § 7803(c)(2)(A) provides that the function of the Office of the Taxpayer Advocate shall be to:

- assist taxpayers in resolving problems with the IRS;
- identify areas in which taxpayers experience problems in dealing with the IRS;
- to the extent possible, propose changes in IRS administrative practices to mitigate these problems; and
- identify potential legislative changes which may mitigate these problems.[4]

Taxpayers seeking the assistance of the Taxpayer Advocate Service generally submit a Form 911, Application for Taxpayer Assistance Order. The National Taxpayer Advocate, and his or her delegates, may issue a Taxpayer Assistance Order (TAO) to the IRS where a taxpayer is suffering or about to suffer a "significant hardship" as a result of the way in which the Secretary is administering the Internal Revenue Code.[5] The TAO provides TAS with the ability to order the IRS to release any property of the taxpayer that has been levied upon, to cease any action, take any lawful action, or refrain from taking any action with respect to the taxpayer in collection and other matters.[6]

The Taxpayer Advocate Service has identified seven specific categories of significant hardship.[7] These categories are:

TABLE 1.21.1, TAS SIGNIFICANT HARDSHIP CRITERIA

Criteria Number	Descritpion
1	The Taxpayer is suffering or about to suffer a significant hardship.
2	The Taxpayer is facing an immediate threat of adverse action.
3	The Taxpayer will incur significant costs if relief is not granted.
4	The Taxpayer will suffer irreparable injury, or long term adverse impact.
5 6	The Taxpayer experienced a delay of more than 30 calendar days in resolving an account-related problem or inquiry.
7	The Taxpayer did not receive a response or resolution by the date promised.
	A system or procedure has either failed to operate as intended or failed to resolve the taxpayer's problem.
8	The Local Taxpayer Advocate has determined it is in the best interest of the taxpayer for TAS to be involved.

[4] IRC § 7803(c)(2)(A)(i)-(iv). The Senate Finance Committee explained its expectations of the Office of the Taxpayer Advocate in this way: "The Committee believes that the Taxpayer Advocate serves an important role within the IRS in terms of preserving taxpayer rights and solving problems that taxpayers encounter in their dealings with the IRS." S. Rep. No. 105-174.

[5] IRC § 7811(a)(1)(A).

Once the Taxpayer Advocate Service accepts a taxpayer's case, it is assigned to a case advocate who will work with the taxpayer until the entire problem is resolved. TAS case advocates report to Local Taxpayer Advocates, who in turn report through the TAS management chain directly to the National Taxpayer Advocate.[8] TAS case advocates are required to address all related issues (including related tax years, related issues, and underlying causes), educate the taxpayer about how the problem arose and what, if anything, can be done to avoid its repetition, and identify any systemic problems that might need to be addressed by the TAS Office of Systemic Advocacy and the IRS.[9]

TAXPAYER ADVOCATE SERVICE CASE INVENTORY

The Taxpayer Advocate Service "stood up" on March 1, 2000. At that time, all cases that qualified for assistance under the IRS' former Problem Resolution Program were entered into the Taxpayer Advocate Management Information System (TAMIS), along with cases that arose as part of the changes generated by the IRS reorganization mandated by Congress in 1998.[10] The initial TAS case inventory was heavily populated with cases involving systemic hardships (Criteria 5 –7), including problems arising from processing delays and lost or "shelved" taxpayer correspondence. During Fiscal Year 2001, the first full year of TAS operation, only 8.8 percent of TAS case closures involved economic hardship (Criteria 1 – 4), compared with 91.2 percent involving systemic hardship. As the IRS matured in the reorganized structure and worked out some problems in return and correspondence processing, however, TAS systemic hardship cases declined relative to economic hardship cases and the nature of TAS case receipts changed from taxpayer service-oriented to compliance-oriented.

[6] IRC § 7811(b). Any TAO issued by the National Taxpayer Advocate may be modified or rescinded by the NTA, or the IRS Commissioner or Deputy Commissioner, and only if written explanation of the reasons for such modification or rescission is provided to the NTA. IRC § 7811(c).

[7] The NTA also may issue a TAO if "the taxpayer meets such other requirements as are set forth in regulations prescribed by the Secretary." IRC § 7811(a)(1)(B). The Committee Conference Report to the Restructuring and Reform Act of 1998 states that "[i]t is intended that the circumstances set forth in regulations be based on considerations of equity." H.R. Conf. Rep. No. 105-599.

[8] Congress mandated that the National Taxpayer Advocate shall appoint at least one Local Taxpayer Advocate for each State. IRC § 7803(c)(2)(D)(i)(I).

[9] Each TAS case advocate has a separate toll-free telephone line and each TAS office has a toll-free fax line so that taxpayers will not be inhibited from communicating with their case advocates because of expense. For a discussion of TAS confidentiality and independence, see National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002),198-215 and National Taxpayer Advocate, *Objectives Report to Congress*, Publication 4054 (Rev. 6-2002).

[10] Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub.L.No. 105-206.

TABLE 1.21.2, ECONOMIC VS. SYSTEMIC HARDSHIP REGULAR CLOSURES COMPARISON

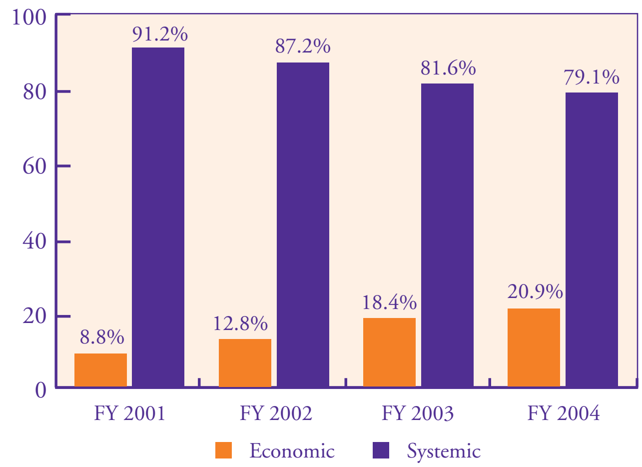
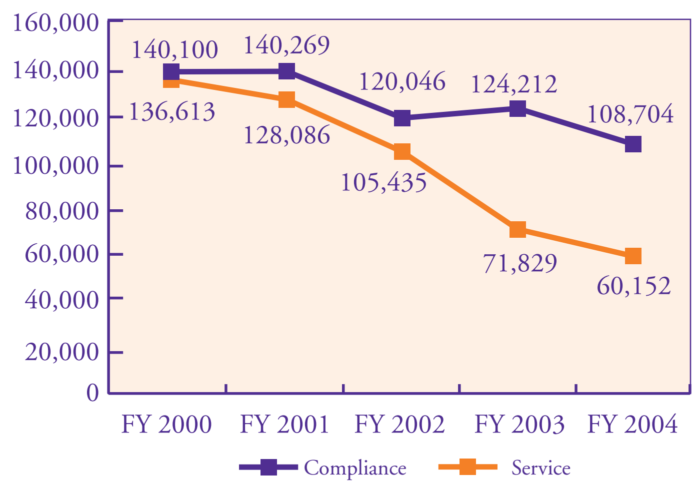


TABLE 1.21.3, TAS COMPLIANCE/SERVICE CASE VOLUME COMPARISON



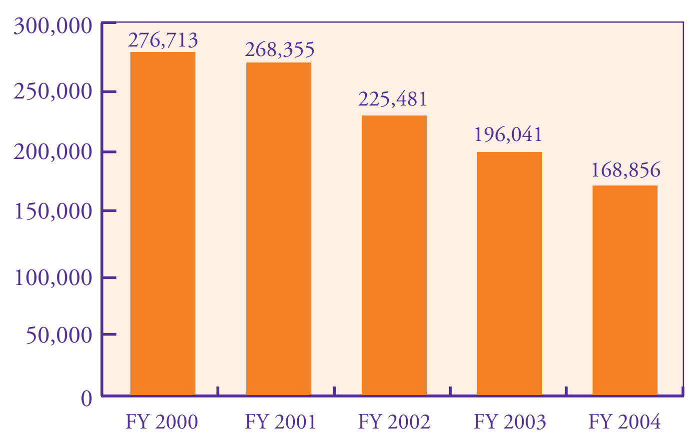
The Taxpayer Advocate Service tracks the primary and secondary reasons for taxpayers seeking TAS assistance. Table 1.21.4 shows the top ten reasons (issues) taxpayers turned to TAS for FY 2001 through FY 2004. Over time, TAS cases have concentrated in work that is increasingly more complex and compliance oriented.

TABLE 1.21.4, SOURCES OF TAS CASEWORK - TOP 10 ISSUES[11]

Description	Ranking			
	FY 04	FY 03	FY 02	FY 01
Criminal Investigation	**1**	**2**	**11**	**22**
Processing Amended Returns	2	3	2	3
Earned Income Tax Credit (EITC) - Revenue Protection Strategy Examinations	3	1	1	1
Levies (Including the Federal Payment Levy Program)	**4**	**5**	**6**	**19**
Processing Original Tax Returns	5	4	3	2
Expedite Refund Requests	6	6	5	4
Audit Reconsiderations	7	8	8	6
Injured Spouse Claims	8	7	4	5
Open Examinations - Non EITC	9	9	9	7
Underreporter Process Reconsiderations	10	11	15	13

Since its inception in March, 2000, TAS case receipts have steadily declined. As Table 1.21.5 shows, TAS case receipts began at a high of 276,713 in FY 2000 and totaled 168,856 for all of FY 2004, or a decline of 39 percent from "stand up."

TABLE 1.21.5, TAS CASE RECEIPTS



[11] The rankings for FY03, FY02, and FY01 were computed for comparisons purposes. The data for these years was converted from the broader Major Issue Codes (MICs) to the new more specific Issue Codes (ICs). MICs generally included more than one of the new ICs. During the conversion, we split the MICs into corresponding ICs based on percentages experienced during FY04. The new codes became effective in April 2003.

Because of the way TAS defines what constitutes a case, however, raw case count does not tell the whole story. Unlike other IRS functions, TAS initiates a single case per taxpayer. In fact, TAS cases usually involve more than one issue and more than one tax period per taxpayer. The IRS Collection function, on the other hand, counts each tax period for each taxpayer as a module or case, as does the IRS Examination function.

> **Example:** The IRS levies upon a taxpayer's bank account, and the cause for the levy is an erroneous Automated Underreporter assessment. The taxpayer seeks TAS assistance. TAS works with the taxpayer and IRS Collection function to stop the levy and, where appropriate, return levy proceeds. TAS also helps the taxpayer convince the IRS Examination function that the assessment is incorrect. These actions count as one case even though TAS has actually addressed three issues.

> **Example:** A taxpayer seeks TAS help with an Earned Income Tax Credit (EITC) problem. The taxpayer has successfully litigated one tax year's EITC in the United States Tax Court but the IRS has not yet posted or issued the overpayment that will result in a refund to the taxpayer. The IRS Correspondence Examination unit selected the following tax year return for examination and has not completed its work yet. Because two years are in dispute, the IRS has frozen the taxpayer's current year EITC. Although this situation involves three years and several issues, it counts as one case.

As discussed earlier, Congress required the Taxpayer Advocate Service not only to help taxpayers resolve their specific problems with the IRS but also to help the IRS resolve systemic problems that plague both the Service and the taxpayers. Thus, one could reasonably argue that the decline in TAS case receipts is a sign of TAS' success at resolving systemic problems. The National Taxpayer Advocate would love to declare victory, fold up her tents, and go home. Unfortunately, both TAS' marketing research and the IRS' shift to Exam and Collection activities – TAS' traditional casework – indicate that declining case receipts mask the real problem – that of not reaching the taxpayers who really need our help.

TAXPAYER ADVOCATE SERVICE CUSTOMER BASE

In August 2001, the Taxpayer Advocate Service retained an outside research firm to define the TAS underserved population and describe its demographic and psychographic characteristics, in order to better serve these taxpayers.[12] As part of this project, the research firm conducted three primary studies:

[12] TAS also asked the research firm to explore practitioner perceptions of TAS, particularly with respect to TAS case referral criteria, so that TAS could correct any misperceptions or confusion.

- *Benchmark Awareness and Usage Study*. This study was conducted via telephone among 2,000 taxpayers and 1,000 tax preparers. The study's purpose was to examine taxpayer and preparer awareness and understanding of TAS, determine whether it was possible to segment the TAS target audience, and build a preliminary profile of the TAS Underserved segments.
- *Qualitative Study of the Underserved Segment.* The purpose of this study was to explore why the TAS Underserved population did not avail themselves of TAS assistance and what TAS could do to reach this population. Toward this end, the research firm conducted eight focus groups representing the Underserved segments identified in the Benchmark study.
- *Quantitative Study of the TAS Underserved Taxpayer Segment.* This study was designed to provide a definitive profile of the TAS Underserved population for use by TAS in its marketing and communications efforts. The research firm conducted 1,400 telephone interviews with TAS Underserved taxpayers.[13]

TAS Underserved Population

As a result of these studies, TAS learned that only three percent of the taxpayers who met TAS Underserved criteria were aware of TAS voluntarily (i.e., without prompting by the interviewer) and only 16 percent were aware of TAS after prompting. Moreover, the number of Underserved taxpayers is substantial. The researchers estimated that between 3.9 and 6.6 million taxpayers qualify as "Currently Underserved" – a group that includes taxpayers who were currently experiencing a TAS qualifying problem. Interestingly, we learned that TAS Currently Underserved includes a mix of incomes and personal circumstances. There is one defining characteristic, however. Two-thirds of the TAS Currently Underserved population had experienced a recent personal or financial loss or illness, which left some unable to pay taxes.[14]

In most demographic measures, TAS Underserveds are very similar to Non-Underserveds and the taxpayer population in general. There are differences, however. Specifically, the TAS Currently Underserved have significantly lower incomes (especially the more recent Underserveds) and are significantly more likely to be small business owners with stagnant or declining businesses.[15]

[13] Russell Marketing Research, Findings From Task 149 – The Taxpayer Advocate Service Research Program: With a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3, (July 2002) at 4.

[14] For a complete discussion of these findings, see Russell Marketing Research, *Findings From Task 149 – The Taxpayer Advocate Service Research Program: With a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3* (July 2002).

[15] Russell Marketing Research, Findings From Task 149 – The Taxpayer Advocate Service Research Program: With a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3 (July 2002) at 17.

TABLE 1.21.6, TAS UNDERSERVED POPULATION - DEMOGRAPHICS

	Total U.S. Taxpayers (Benchmark A&U)	Total U.S. Taxpayers Who Never Experienced TAS Qualifying Problem (Benchmark A&U)	Total U.S. Taxpayers Who Experienced TAS Qualifying Problem Past 2 Years (Study of Underserveds)	Total U.S. Taxpayers Currently Experiencing TAS Qualifying Problem (Study of Underserveds)
Total Interviews	(2,000) %	(1,651) %	(1,400) %	(762) %
Demographics				
Median HH Income Before Taxes	**$44.7**	**$44.4**	**$41.4**	**$37.5**
Specific Income Categories				
Under $17,000	**9**	**8**	**12**	**15**
$17,000 fo $24,999	10	10	11	12
$25,000 to $34,999	14	13	13	14
$35,000 to $49,999	18	19	16	16
$50,000 to $74,999	18	17	15	14
$75,000 to $99,999	9	10	9	7
$100,000 or more	11	10	10	9
% Business Owners	**11**	**10**	**16**	**19**
New Base: Total Business Owners	(226)	(159)	(229)	(144)
Q49-% with Growing Business	42	42	35	38
Q49-% with Stagnant or Declining Business	**38**	**38**	**65**	**62**

We were able to segment the TAS Underserved population by their demographics, behavior, and personal situations. The three largest segments are the Stable Middle Class, Unmarried Poor, and Affluent Families. A brief summary of each of the segments follows.

- *The Stable Middle Class* – This is the largest Underserved segment (32 percent). They are average in most respects, except that they are more likely to be married with children, have high involvement in their tax returns, and are more likely than most other segments to have used government programs and services.
- *Unmarried Poor* – The next largest segment (at 17 percent) – is very similar to group 7 *(Struggling Young Families)* in that they are younger, blue collar, lower income, high in use of government programs/services, low in health insurance coverage, and high in recent personal or financial losses which leave them unable to pay taxes. They differ from group 7 in that they are not married, and have fewer children and smaller households.

- *Affluent Families* (15 percent of all Underserveds) – This is a high-income group, average in age, but more likely to be married, have children, and be employed. This group has the highest presence of small business owners.
- *Empty Nesters* (12 percent) – This is the 2nd-oldest segment (behind *Surviving Spouses*). Its members are generally married couples with few children at home and somewhat higher than average in income. It has the second-highest presence of small business owners, and is highest (along with *Surviving Spouses*) in recent personal or financial losses.
- *Income-Secretive* (11 percent) – The taxpayers in this group refuse to talk about their income, are generally middle-aged couples with few children, and have the lowest level of personal or financial losses or illness.
- *Surviving Spouses* (7 percent) – This group mainly consists of older widows who live alone and are low income, have a high use of paid preparers, and are not involved in their taxes. These taxpayers have experienced recent personal or financial losses or illness -- leaving 10 percent of them unable to pay taxes.
- *Struggling Young Families* (7 percent) – The members of this group are similar to the *Unmarried Poor* except that they are married with larger households. They are most likely to say that recent losses or illness have left them unable to pay taxes.

When respondents self-rated their attitudes toward the Internal Revenue Service, most TAS Underserveds are either "intimidated" or "distrustful" of the IRS and its processes. In fact, TAS Underserveds differ from other taxpayers in terms of both behavior and attitude. Behaviorally, TAS Underserveds include fewer "Stable Middle Class" and "Unmarried Poor" and more of the other segments. Attitudinally, they are more likely to be Intimidated than Distrustful of the IRS and its processes.[16]

[16] Russell Marketing Research, Findings From Task 149 – The Taxpayer Advocate Service Research Program: With a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3 (July 2002) at 21.

TABLE 1.21.7, TAS UNDERSERVEDS – BEHAVIOR AND ATTITUDE

	Total U.S. Taxpayers (Benchmark A&U)	Total U.S. Taxpayers Who Never Experienced TAS Qualifying Problem (Benchmark A&U)	Total U.S. Taxpayers Who Experienced TAS Qualifying Problem Past 2 Years (Study of Underserveds)
Total Interviews	(2,000)	(1,651)	(1,400)
	%	%	%
The 7 Behavioral Segments			
Affluent Families	12	12	15
Empty Nesters	9	8	12
Stable Middle Class	**50**	**50**	**32**
Surviving Spouses	3	3	7
Struggling Young Families	3	3	7
Unmarried Poor	19	19	17
Income-Secretive	5	6	11
The 3 Attitudinal Segments			
Acceptors	29	30	26
Intimidated	**25**	**25**	**43**
Distrustful	41	38	31

In terms of psychographic characteristics, TAS Underserved taxpayers differ from other taxpayers by having greater concerns about money, debts, and not being able to pay taxes. Further, they are more likely to have used government services and programs, are less likely to have health insurance, and have a greater incidence of personal or financial loss or illness (which results in financial hardship).[17]

[17] Russell Marketing Research, Findings From Task 149 – The Taxpayer Advocate Service Research Program: With a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3 (July 2002) at 45.

TABLE 1.21.8, TAS UNDERSERVED - PSYCHOGRAPHICS

	Total U.S. Taxpayers Who Experienced TAS Qualifying Problem Past 2 Years (Study of Underserveds)
Total Interviews	(1,400) %
Types of TAS-Qualifying Problems Experienced Past 2 Years	
Net Experienced a Qualifying Problem Past 2 Years	100
1. Suffering a signficant hardship	51
2. Delay of 30+ days in IRS resolution of problem	32
3. Incurring significant cost	29
4. Irreparable financial injury/long-term impact	24
5. IRS systems/procedures failed to operate as intended	22
6. No resolution from IRS by date promised	18
7. Facing immediate adverse action	12

TABLE 1.21.9, TAS UNDERSERVED – FINANCIAL CONCERNS

	Total U.S. Taxpayers (Benchmark A&U)	Total U.S. Taxpayers Who Never Experienced TAS Qualifying Problem (Benchmark A&U)	Total U.S. Taxpayers Who Experienced TAS Qualifying Problem Past 2 Years (Study of Underserveds)
Total Interviews	(2,000) %	(1,651) %	(1,400) %
Personal Situations			
Ever used EITC, WIC, Head Start, Food Stamp Welfare-to-Work Programs/Services	30	28	37
Non-english oriented	4	4	5
% With no health insurance	11	10	17
% Better off than other family members	22	20	21
% With recent personal/financial loss or major illness	49	47	66
New base: Total Experience Major Life Event			
% Saying loss left them unable to afford things	15	13	33
% Saying loss left them unable to pay taxes	5	3	13

When the TAS Underserved taxpayers were asked to identify which of TAS' seven specific qualifying criteria they had experienced in the past two years, the most common criteria was "Suffering a significant hardship." This criteria was present in 51 percent of the taxpayers' situations, in contrast to 11 percent of TAS cases during FY 2002.[18]

TABLE 1.21.10, TAS UNDERSERVED – TAS QUALIFYING CRITERIA

	Total U.S. Taxpayers Who Experienced TAS Qualifying Problem Past 2 Years (Study of Underserveds)
Total Interviews	(1,400) %
Types of TAS-Qualifying Problems Experienced Past 2 Years	
Net Experienced a Qualifying Problem Past 2 Years	100
1. Suffering a signficant hardship	51
2. Delay of 30+ days in IRS resolution of problem	32
3. Incurring significant cost	29
4. Irreparable financial injury/long-term impact	24
5. IRS systems/procedures failed to operate as intended	22
6. No resolution from IRS by date promised	18
7. Facing immediate adverse action	12

After being exposed to the description of the Taxpayer Advocate Service and the services it offers, 62 percent of the Underserved population indicated interest in using it ("very" or "somewhat" likely to use TAS), with 30 percent saying they were "very likely" to use TAS. Thus, by applying the 30 percent "very likely" figure to the 3.9 to 6.6 million taxpayers that were determined to have been eligible for TAS, the research firm concluded that *1.2 to two million taxpayers with a TAS qualifying problem would be very likely to use TAS, if only they knew about TAS.*[19]

Taxpayer Advocate Service Outreach Strategy

In response to these findings about its taxpayer base, the Taxpayer Advocate Service developed an outreach and marketing strategy directed to several of the TAS Currently

[18] Russell Marketing Research, Findings From Task 149 – The Taxpayer Advocate Service Research Program: With a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3 (July 2002) at 25; National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), 387.

[19] *Id*. at 46. The Benchmark study concluded that 4 percent of the taxpayer population met the definition of "Currently Underserved." It applied that percentage to the 131 million 2001 taxpayer base and concluded that the entire TAS Currently Underserved population ranged from 3.9 to 6.6 million. *Id*. at 7. Of that population, 62 percent were potentially interested in TAS' services (2.5 to 4.1 million); as noted above, 30 percent (or 1.2 to 2 million) Currently Underserved taxpayers were very likely to use TAS. *Id*. at 46.

Underserved taxpayer segments. These segments are Struggling Young Families, Unmarried Low Income, and Surviving Spouses.

The marketing campaign included public service announcements, brochures, posters, and media interviews. During FY 2004, TAS tested the marketing campaign in seven communities.[20] TAS also conducted a nationwide campaign test for the Preparer, Small Business, and Spanish-speaking taxpayer segments. As part of this campaign, the National Taxpayer Advocate conducted a satellite media and audio tour in February 2004, which reached an estimated 1.1 million listeners and viewers. During FY 2005, TAS plans to expand all aspects of its marketing strategy.[21]

In addition to this specific marketing campaign, since TAS' inception, each Local Taxpayer Advocate has been required to develop and conduct a comprehensive annual outreach plan for his or her geographic base. These customary outreach activities include Congressional visits, Low Income Taxpayer Clinic visits, practitioner group meetings and small business outreach. Table 1.21.10 shows the number of TAS outreach events nationwide during FY 2004, by audience type.

TABLE 1.21.11, TAS OUTREACH EVENTS[22]

Audience	Number of Events	Number of Participants
Congressional	368	3,563
EITC / LITC	162	3,782
External Outreach	399	260,268
Media	81	8,118,927
Other	153	12,750
Practitioners	515	109,103
Senior Citizens	31	10,121
Small Business	179	99,428
Total	**1,888**	**8,617,942**

[20] These communities are Houston, Tampa, Buffalo, Detroit, Chicago, Tucson, and New Orleans.

[21] TAS will target nine additional markets: Orlando, Miami, Pittsburgh, Cleveland, Minneapolis, Denver, Phoenix, Sacramento, and Los Angeles. During FY 2005 the campaign will cover a total of 16 markets, and all media outlets will receive radio and print public service announcements (PSAs). Based on the exceptional response from the satellite media and audio tour conducted by the National Taxpayer Advocate in February 2004, TAS will conduct another such tour in early February 2005 to provide additional exposure of TAS and the contents of the 2004 Annual Report to Congress.

[22] The count of Outreach events excludes National Taxpayer Advocate speeches and media coverage. During FY 2004, the National Taxpayer Advocate led over 40 outreach sessions with external customer organizations, was cited in over 500 news articles, and appeared on several televised newscasts including *Washington Journal, Nightly Business Report, Frontline, and News Hour with Jim Lehrer*.

The Taxpayer Advocate Service is also initiating a grassroots outreach campaign during FY 2005 to reach underserved taxpayers who may need our services but do not know about TAS. The premise of this grassroots campaign is that word-of-mouth and presence in the community are effective ways for TAS to reach those taxpayers in need of TAS services. Quarterly, each Local Taxpayer Advocate (LTA) is required to contact ten organizations in his or her community that serve one of TAS' target customer segments and that have never been contacted by TAS. The LTA, along with appropriate staff, is required to meet (by phone or in person) with the organization's key personnel, learn about their services and beneficiary population, explain how TAS can help their beneficiaries, offer to conduct an information or help session or partner in other ways, and send TAS brochures for the organization to distribute to its beneficiaries. LTAs must also follow up quarterly with these organizations to answer any questions and make sure they receive additional brochures if necessary.

The National Taxpayer Advocate wants TAS to think beyond traditional events and presentations to try to improve its presence in communities. To do this, we must reach out to community organizations, legal aid societies, domestic violence shelters, and other such organizations. We must inform underserved taxpayers about our program and its ability to help them if they have a financial hardship or are having a problem with the IRS resolving their tax issues. TAS is currently developing helpful products, including an LTA "toolkit" and an outreach database, to assist LTAs in outreach visits and contacts. We are also working with professional and community groups to include information about TAS in their own public service announcements, as appropriate.

Each Local Taxpayer Advocate is responsible for all tax account-related issues originating from Congressional offices. Within each state, the LTA provides a coordinated outreach effort to the local Congressional delegations. To assist the LTAs with this task, TAS has developed a guide for Congressional visitation and outreach efforts and is developing a Congressional district analysis. This latter program will provide TAS with a tool to determine how Congressional offices may assist us in identifying and reaching underserved populations within each Congressional district.

A well-researched, well-designed, and well-funded formal outreach campaign, combined with grassroots local initiatives, will enable the Taxpayer Advocate Service to get the word out about TAS to those taxpayers who need TAS help the most. For TAS to effectively reach those taxpayers who need its services, however, the 98,000 other employees of the IRS must be informed about TAS and refer taxpayers to TAS when they need us.

IRS' Role in Providing Access to TAS

In October 2001, the Treasury Inspector General for Tax Administration (TIGTA) issued a report noting that the Internal Revenue Code requires the National Taxpayer Advocate to develop guidance about eligibility criteria and educate all IRS employees about those criteria. TIGTA found that the Taxpayer Advocate Service needed to do a better job at educating IRS employees about TAS eligibility and at tracking who received this training.[23]

In response to the TIGTA audit, TAS developed its TAS Annual Guidance for *IRS Officers and Employees* (Document 11189 Certification Process). Initially, in an effort to correct the deficiencies TIGTA identified, Local Taxpayer Advocates and other TAS employees would attend thousands of IRS continuing professional education (CPE) programs annually, provide specific training on TAS eligibility criteria, and manually record who attended these CPEs. In FY 2004, TAS employees conducted 945 such briefings.

TAS has now converted this course to an on-line briefing and certification process. This approach will ensure maximum IRS-wide web deployment that is both effective and efficient for TAS and IRS use. The course will be available to all IRS employees along with the other IRS annual mandatory briefings (e.g., ethics) in May 2005.

While these general annual briefings are a good introduction to TAS criteria, it is equally important that the IRS educate its employees about the availability and importance of TAS assistance at transaction- and program-based trainings. We discuss this issue in depth in the Most Serious Problem entitled *Taxpayer Rights Training in a Complex and Changing Tax Environment*, herein. In fact, TAS needs to be invited to IRS examination and collection manager meetings on a national, area or territory level to:

- Remind managers about TAS' statutory mission to help taxpayers who experience problems with the IRS;
- Educate managers about the specific eligibility requirements for TAS assistance and why it benefits the IRS to make referrals of these eligible taxpayers to TAS; and
- Discuss fact patterns of cases that may be referred and of cases that should have been referred but were not.

TAS personnel could illustrate this training by providing specific examples of cases that qualify for TAS assistance.

Taxpayer Advocate Service customer satisfaction data indicate that 55 percent of all taxpayers who received assistance from TAS and 40 percent of taxpayers who did not receive relief from TAS felt better about the IRS as a whole because of their experience with TAS.[24] Clearly, IRS senior and mid-level managers should encourage all IRS employees to strive for one-stop service. Where such service does not occur, however, executives and

[23] Treasury Inspector General for Tax Administration, *The National Taxpayer Advocate Needs to Ensure Operations Employees Receive Training to Identify Cases*, Reference No. 2001-100230, (Oct. 17, 2001).

[24] The Gallup Organization, *Customer Satisfaction Survey, Quarter 14 (April-June 2004)*, Sept. 10, 2004.

managers should encourage their employees to refer cases to TAS. TAS customer satisfaction surveys clearly show that referring such cases, where significant hardship is demonstrated, is not only good for taxpayers – it's good for the IRS! Moreover, sending problem cases to TAS truly helps the Operating Divisions identify and focus on significant problems that need to be addressed.

Local IRS managers should be encouraged to invite the Local Taxpayer Advocate to meetings to discuss examples of TAS cases and TAS criteria for referrals. The LTAs can also discuss systemic issues that TAS has identified in the particular program areas, and obtain IRS employees' recommendations for systemic change.

At present, reaching the Taxpayer Advocate Service is not an option on any menu on the IRS Toll-Free phone service other than Tele-Tax Topics. Thus, taxpayers must already know about TAS and specifically ask to be transferred to TAS when they reach a live operator. Moreover, despite the Congressional mandate that local Taxpayer Advocate Service phone numbers be listed separately from the IRS in local phone books, TAS struggles regularly with various IRS offices to obtain funding to place our phone numbers in local directories.[25]

Prior to 2000, Problem Resolution Officers (predecessors to Local Taxpayer Advocates) regularly conducted operational reviews of various IRS functions, including examination, collection, offers-in-compromise (OIC), automated collection system (ACS), and special procedures. The Problem Resolution Officer (PRO) would randomly pull case files to check for aged correspondence, overdue lien releases, and aged exam, collection, and OIC cases. PROs would monitor calls into and from the ACS sites to determine if ACS employees recognized cases appropriate for referral to the PROs. Problem Resolution Officers undertook a different functional review each quarter, but each function was subject to a review annually.

Under the Problem Resolution Program Case Identification Tracking program (PRPCIT), Problem Resolution Officers sent Problem Resolution employees into IRS mailrooms. There, PRP employees would review incoming correspondence and identify cases that appeared to qualify for the Problem Resolution Program. These employees would assign a tracking number to the correspondence and track it through the campus system to determine when and if any IRS employee would notice that the case met PRP criteria and should be referred to a PRO.

These programs clearly provided the Problem Resolution Officer with empirical evidence as to what functions needed additional training about PRP criteria and referrals. The Internal Revenue Service should cooperate with the Office of the Taxpayer Advocate to re-institute these programs immediately.

[25] IRC § 7803(c)(2)(C)(iii).

CONCLUSION

It is imperative that IRS devote resources to making taxpayers aware of the Taxpayer Advocate Service. TAS needs to continue its carefully targeted marketing outreach campaign and needs to train IRS employees more thoroughly about when it is appropriate to inform taxpayers about their eligibility for TAS' services.

A clear message of the Internal Revenue Restructuring and Reform Act of 1998 is that IRS must do a better job of balancing enforcement against customer service and the protection of taxpayer rights. IRS is properly increasing its enforcement program. TAS must be able to play a central role – perhaps the central role – in ensuring the protection of customer service and taxpayer rights. But if most taxpayers have never heard of TAS, and only four percent of eligible taxpayers are using TAS services, TAS cannot protect taxpayer rights to the extent intended by Congress.

IRS COMMENTS

The IRS agrees with the TAS report that all IRS employees should be knowledgeable of the role of TAS in the organization and ensure that taxpayers have access to TAS resources as appropriate. Knowledge of TAS can be acquired through various means – training material, IRM guidance, face-to-face meetings, or group presentations.

The IRS will continue to review technical training materials to ensure that courses, regardless of the method of delivery, incorporate a concern for taxpayer rights and the role of TAS. The IRS is committed to maintaining a close, cooperative, inter-functional relationship between TAS and all other business units at all levels. Examples of this commitment include the following:

- The IRS would welcome the opportunity to include articles about TAS in Managers' Messages or Headline News to ensure employees are aware of the role of TAS. In addition, TAS could create a simple presentation for use by Compliance managers in staff meetings to remind employees of the TAS resources available to them.
- The various IRS business units will continue to meet with TAS employees at national and local levels as time and resources permit.
- Through the IRS Toll-Free telephone services, Accounts Management Customer Service Representatives will continue to provide triage-like service for taxpayers by analyzing a particular taxpayer's situation, resolving the issues if possible, and initiating a referral to TAS if the appropriate criteria are met. This procedure was previously coordinated with TAS to ensure that taxpayers who are referred to TAS satisfy the appropriate criteria. The IRS would be happy to work with TAS to explore enhancements to these services.

- Form 911, Application for Taxpayer Assistance Order, is included in Publication 1796, Federal Tax Products CD-ROM, which approximately 41 percent of the IRS's 12,000 participating libraries order and make available to their customers. Other libraries allow their customers to directly link to the Internet, where they can download IRS products on irs.gov. Pub. 1796 is also sent to more than 23,000 community Based Outlet Program participants (e.g., local governments, corporations, credit unions), who provide electronic access to their customers and employees. Finally, the publication is also purchased by more than 22,000 tax professionals, providing them with electronic access to Form 911. The IRS would be happy to work with TAS to consider other options for making Form 911 readily available to taxpayers.
- In December, 2004, the IRS's Stakeholder Partnerships, Education and Communication (SPEC) organization introduced its Partner/Volunteer web page on irs.gov with resources for all SPEC external stakeholders and volunteers. The web page is accessible and frequently used by all SPEC employees and SPEC partners who consist of over 60 national partners, 265 coalitions that represent thousands of local partners, and over 70,000 volunteers. The web page links directly to both the TAS web page and the Taxpayer Rights Publication 1.

TAXPAYER ADVOCATE SERVICE COMMENTS

We appreciate the suggestions made by the agency to improve accessibility to TAS and for the efforts that have been made thus far. However, we strongly believe there is much room for improvement to ensure that the almost six million taxpayers eligible for TAS services actually know that TAS exists and is available to them.

Access to TAS through IRS Training

Although IRS agrees that all IRS employees should be knowledgeable of the role of TAS, the IRS must fully commit to formal training of IRS employees each year on TAS criteria. Employees should be instructed by management on the importance of taxpayer rights and when how and to refer cases to TAS. All toll-free assistors should be aware of TAS criteria and the triage techniques mentioned in the IRS response. It is not enough that the NTA toll-free assistors are knowledgeable about when to refer cases to TAS.

TAS has continuously updated training materials and has provided these materials to IRS consistently since the reorganization. TAS employees have actively solicited time on IRS training, CPE, and meeting agendas. Obstacles to participation in these meetings by TAS have included lack of time on agendas and IRS failure to notify TAS of when these meetings occur. There continues to be a need for reinforcement by IRS senior management that TAS should be invited to the table in meetings, CPEs, and training.

TAS has recently developed a web based training program that describes TAS' mission, statutory and delegated authorities, and criteria for case referrals, and includes teaching examples. TAS has requested that this lesson become a mandatory annual training for IRS employees, along with Unauthorized Access (UNAX) and Prevention of Sexual Harassment (POSH) training. TAS has also included messages in Headlines, Leader's Digest, and other all employee venues regarding TAS services. TAS includes messages regarding TAS criteria each month on the IRWeb (the IRS intranet) under news from the business units.

Access to TAS in IRS Publications

We are pleased that the Form 911 is included in Publication 1796, Federal Tax Products CD-ROM. However, Publication 1796 is not accessible to all taxpayers. The publication is a CD-ROM and thus is available only to taxpayers with computer access. Publication 1796 is also only available to community based outlet program participants or must be purchased by the public. We have requested that IRS include Form 911 in the laminated forms package, Publication 3194 (another publication distributed through the community based outlet program) so that taxpayers that do not have access to computers or lack computer skills can obtain the form. While we understand that this publication generally only contains the most requested forms for the filing season, we believe that Form 911 should be the exception to the rule, given the important role it plays in providing access to TAS and protecting taxpayer rights. Taxpayers need to know that they have access to TAS from numerous sources.

In November and December of this year, TAS Communications & Liaison analysts began a review and analysis of the several hundred IRS internal and external communication vehicles associated with the filing season. This review is not complete, but in its initial stages it identified several significant IRS products or vehicles that currently fail to include TAS messages. For example, field guidance to employees providing tax-filing assistance to IRS employees neglects to mention TAS. Others include:

- *Combat Zone, a fact sheet for active-duty military on how to get IRS tax help, does not mention TAS.*
- *A PowerPoint speech called "Tax Tips for Families" and fact sheet on the Low Income Tax Clinic produced by Wage & Investment Communication and Liaison does not mention TAS.*
- *The main index page of the IRS Spanish language website, "El IRS en espanol," does not contain a hypertext link to TAS.*
- *Various news releases associated with the filing season do not include either hypertext links to TAS or "Know your Rights as a Taxpayer," which links to TAS. Examples from the 2004 filing season include "Last Minute Filers," (April 14, 2004); "Avoid Paying Tax Penalties"(undated template-style news release) and "Electronic options Help with Tax Payments" (April 9, 2004). Examples from the 2003 season include the main release, "Filing Season Begins with New Features on IRS.gov" (Jan. 2, 2003).*

TAS analysts are currently working with developers of some of these products and we are optimistic that this cooperation will continue. In many cases, it will be necessary to contact program owners in order to continue this analysis and identify other vehicles where the TAS message either needs to be included or deserves higher prominence. We acknowledge the openness of the individuals we have contacted so far and will continue to work with others to include and enhance TAS messages.

Access to TAS through IRS Website

We have found that TAS is generally buried within certain sites on IRS.gov where we believe that TAS should have a stronger presence. For example, on the Partner Products and Volunteer Center page mentioned in the IRS response, TAS is only mentioned under resources on the left-navigation column. There is no information regarding TAS on the page itself. There is also nothing about the Taxpayer Advocacy Panel, which is a significant volunteer program administered by TAS, or the Low Income Taxpayer Clinic (LITC) organization. When a taxpayer clicks on the Partner And Volunteer Information Center, a site that includes short, but important, federal tax messages that IRS volunteers or partners can tuck into public announcements and speeches, use in newsletters, or post to websites, only two topics are listed: EITC and E-File. TAS should also be listed as a topic.

Under the Frequently Asked Questions page, a taxpayer may search under category or keyword. When we searched by keywords such as Taxpayer Advocate Service, Taxpayer Rights, Hardship, or Problem, no information appeared. We will work with the IRS to ensure that these key words are included and the information reflected direct people back to TAS.

We were recently encouraged by the cooperation provided to us when we requested that TAS be elevated on the 1040 Central site. We have requested that TAS be elevated to the first bullet under the "Need More Help" site.

The above examples illustrate where the TAS message is either non-existent or needs more prominence. IRS employees need to understand the unique services provided by TAS and when cases should be referred to it. Notwithstanding some recent IRS progress and commitments, the National Taxpayer Advocate finds one comment by the IRS in its response to be indicative of the IRS' current approach to TAS.

IRS Commitment to Actively Promote TAS

The IRS states that IRS business units will meet with TAS nationally and locally "as time and resources permit." TAS is very conscious of the multitude of demands on IRS employees' and management time. TAS' own management and employees face these same time constraints. Thus TAS has every incentive to seek only those meetings that enable TAS to fulfill its statutory mandate. Since this mandate is to help taxpayers solve their problems with the IRS and identify administrative and legislative proposals to mitigate those problems, it is in the best interests of the IRS as well as taxpayers to refer cases to TAS. TAS should not be viewed by the IRS as something it will schedule in merely at its own convenience.

The IRS does not commit to publicizing TAS externally beyond passive communication media (i.e., taxpayers must search and find out about TAS). This approach makes the IRS itself the gatekeeper to taxpayer's access to TAS. If the IRS refers taxpayers, then TAS will have cases and taxpayers receive help. If the IRS decides that it requires too many "resources" or too much time to refer cases to TAS, then TAS will not have cases and taxpayers will be harmed. Thus, it is imperative that the IRS assist TAS in publicizing itself through external media, independent of case-specific referrals.

Finally, TAS must be adequately funded both to externally publicize the availability of its services and to properly work the taxpayer cases that such publicity should generate. The Service's failure to fund TAS will limit taxpayer access to TAS and increase taxpayer dissatisfaction with the overall tax system.

The IRS has provided a good start to working with our staff to provide improvements as we have requested. We hope this cooperation continues as we work towards ensuring that the potential 5.25 million taxpayers who could benefit from our services are able to do so. The Taxpayer Advocate Service must no longer be the "best kept secret in the IRS."

INTRODUCTION

Section 7803(c)(2)(B)(ii)(VIII) of the Internal Revenue Code requires the National Taxpayer Advocate to include in her Annual Report to Congress, among other things, legislative recommendations to resolve problems encountered by taxpayers.

Immediately following this introduction, we present a chart showing how recent National Taxpayer Advocate legislative recommendations fared in the just-concluded 108th Congress. We are pleased to note that four proposals we recently recommended have become law – a uniform definition of a child,[1] an "above-the-line" deduction for contingent attorney fees and attorney fee awards in certain nonphysical personal injury cases,[2] authorization for the IRS to enter into partial-pay installment agreements,[3] and the availability of income averaging for commercial fishermen.[4] In addition, at least a dozen of our recommendations have passed either the full House as part of H.R. 1528, the Taxpayer Protection and IRS Accountability Act, or the full Senate as part of S. 882, the Tax Administration Good Government Act.[5] While the last Congress ended before the House and Senate had an opportunity to bring these bills to conference, we anticipate that most of the provisions will be considered again in the 109th Congress.

In this report, we are presenting two broad categories of Key Legislative Recommendations – one dealing with the need for tax simplification and the other dealing with the protection of taxpayer rights.

The Key Legislative Recommendations dealing with tax simplification are as follows:

Alternative Minimum Tax (AMT). The AMT, originally designed to prevent wealthy taxpayers from escaping taxation through the use of tax-avoidance transactions, has morphed into a second layer of taxation that is increasingly affecting middle income taxpayers and is projected to expand to affect nearly 35 million taxpayers in 2010. In our

[1] Working Families Tax Relief Act, Pub. L. No. 108-311, § 201 (2004).

[2] American Jobs Creation Act, Pub. L. No. 108-357, § 703 (2004).

[3] *Id.* at § 843.

[4] *Id.* at § 314.

[5] The House bill contained our recommendations to exempt husband-and-wife co-owned businesses from the partnership filing requirements in most cases; to convert the penalty for failure to pay estimated tax into an interest charge; to require that interest be abated on certain erroneous refunds; to authorize the Secretary to grant a one-time abatement of penalties for first-time filers or filers with a consistent history of compliance; to reduce the penalty for failure to make payroll tax deposits in the manner prescribed from 10 percent to two percent; to enhance the confidentiality of taxpayer communications with the Office of the Taxpayer Advocate; to give the National Taxpayer Advocate the authority to hire independent counsel; to authorize IRS employees to disclose information to local authorities when they hear imminent suicide threats; to authorize reinstatement of funds to retirement accounts when the IRS levied on the accounts in error or in flagrant disregard of rules or regulations; and to extend the time within which taxpayers or third parties can request a return of levied funds or the proceeds from the sale of levied property from nine months to two years from the date of levy. The Senate bill contained some of the foregoing recommendations as well as our recommendation to regulate unenrolled Federal income tax preparers.

2003 report, we designated the AMT as the most serious problem facing taxpayers. We recommend that Congress repeal the AMT or revamp it substantially to achieve its original objective.

Small Business Tax Burdens. The Internal Revenue Code imposes significant burdens on small businesses. We recommend that Congress adopt a number of proposals designed to alleviate some of these burdens. Our proposals include allowing self-employed taxpayers to deduct the costs of health insurance premiums for purposes of self-employment taxes; extending the deadline by which a newly formed corporation must file an election to be treated as an S corporation until the date on which the corporation is required to file its first tax return; and protecting businesses that use payroll service providers from tax deposit fund misappropriation, or even fraud, by requiring payroll services to meet certain minimum qualifications. We also reiterate our previous proposals to reduce the maximum penalty for failure to make payroll tax deposits in the manner prescribed from 10 percent to two percent and to exempt husband-and-wife co-owned businesses from the partnership tax filing requirements in most cases.

Education Tax Incentives. The Internal Revenue Code provides a complex set of incentives to encourage saving for and spending on education, set forth in at least nine different provisions. The requirements, definitions, and income phase-outs vary from provision to provision. The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior. But taxpayers will only respond to incentives if they know they exist and understand them. Few, if any, taxpayers are both aware of each of the education tax incentives and familiar with their particulars. We make several specific recommendations to streamline and simplify these provisions.

Retirement Saving Tax Incentives. Much like education incentives, retirement planning incentives are numerous and complex. More than a dozen tax-advantaged retirement planning vehicles are available, and they are subject to different sets of rules governing eligibility, contribution limits, the tax treatment of contributions and distributions, withdrawals, the availability of loans, and portability. We recommend that Congress take a hard look at the confusing array of options, and we suggest guidelines that Congress could consider to streamline the available options.

The second category of Key Legislative Recommendations, which relate to the protection of taxpayer rights, is as follows:

Effective Tax Administration Offers in Compromise. In 1998, Congress authorized the IRS to compromise tax debts based upon factors such as equity, public policy and hardship in cases where doing so would promote the effective administration of the tax laws (ETA offers). However, the IRS has interpreted the congressional authorization narrowly so that, for example, the IRS group charged with evaluating such offers accepted only a single ETA offer based upon equity or public policy in FY 2004. We believe that the IRS' reluctance to compromise in inequitable situations may lead taxpayers to disregard the law or erode their faith in the fairness of the income tax system. We recommend that Congress provide more specific guidance to the IRS to ensure that offers submitted under a new "Equitable Considerations" standard are accepted in a broader array of cases.

Collection Due Process Hearings. In this section, we make the case that Collection Due Process (CDP) hearings are an important vehicle for ensuring that the IRS follows the appropriate and required administrative and legal procedures and considers all reasonable collection alternatives in the course of collecting outstanding tax liabilities. To keep the focus on collection activity, we recommend that taxpayers continue to be permitted to raise concerns about the underlying liability during the administrative CDP hearing but propose repeal of the ability to have *de novo* judicial review of the underlying liability. We also recommend a number of technical legal and administrative improvements, including proposing forms and notices to help taxpayers navigate and prepare for CDP hearings and create a more accurate administrative hearing record.

Free Basic Electronic Return Preparation and Filing. In 1998, Congress directed the IRS to work toward a goal of having 80 percent of all returns filed electronically by 2007. This is a desirable goal because e-filing benefits taxpayers and the IRS alike. However, taxpayers who self-prepare their returns find that paper filing is free but e-filing may require them to pay two separate fees to a private vendor – one fee for preparing their return electronically and a second fee for filing their return electronically. In 2002, the IRS entered into a three-year agreement with the Free File Alliance to provide free e-filing to at least 60 percent of all taxpayers. We recommend that Congress take the next step by requiring the IRS to post fill-in forms on its website and make e-filing free for all taxpayers who self-prepare their returns. (Taxpayers who prefer to avail themselves of the additional benefits of a sophisticated software program would, of course, remain free to purchase and use one.)

The Tax Gap. The final discussion in the section on taxpayer rights relates to the tax gap. The most recent IRS estimate of the net tax gap, for 2001, was $255 billion. Last year, 128 million taxpayers filed individual income tax returns. Thus, every taxpayer is forced to pay an average of about $2,000 extra in taxes each year to subsidize noncompliance. At a hearing on the tax gap convened by the Senate Finance Committee in July, virtually all witnesses agreed that the cash economy and other types of income not currently subject to document matching are the biggest sources of the tax gap.[6]

[6] Cash economy noncompliance was discussed with each of two panels at the hearing. During the first panel, Joseph Bankman, professor of law and business at Stanford Law School, defined the cash economy as cash or checks not subject to third-party reporting. During the second panel, Senator Max Baucus referred to the problem as involving "sole proprietorships and cash accounting."

The Office of the Taxpayer Advocate has two primary concerns with respect to the growing tax gap. First, the mere fact that honest taxpayers are paying so much extra in taxes due to noncompliance constitutes an extraordinary abridgement of taxpayer rights and raises fundamental issues of fairness. To help alleviate the tax gap's burden, we are presenting an extensive list of options that Congress and the IRS should evaluate. Second, any new or enhanced enforcement measure has the potential itself to abridge taxpayer rights. For that reason, we must analyze these options from the perspective of taxpayer rights. In a chart describing possible options, we note the obvious benefits and burdens of each option. As the IRS and Congress begin to grapple with the tax gap in the near future, we will raise specific concerns and even objections, depending on the extent to which the development and implementation of new enforcement measures undermine the rights of specific taxpayers.

Additional Legislative Recommendations. Finally, we offer two technical legislative recommendations. One would suspend the statutory period for filing a petition in the U.S. Tax Court with respect to certain Code provisions while a taxpayer is prohibited from filing a petition due to an automatic stay imposed by a U.S. bankruptcy court. The other would allow the IRS to issue refunds or credits after a Tax Court decision is entered in a small case proceeding but before the decision becomes "final."

STATUS OF NATIONAL TAXPAYER ADVOCATE'S LEGISLATIVE RECOMMENDATIONS 108TH CONGRESS

Recommendation	Bill No.	Sponsor	Date	Current Status
Family Issues				
Uniform Definition of a Qualifying Child	**HR 1308**	**Thomas**	**3/18/2003**	**Public Law No: 108-311 on 10/4/2004**
Means Tested Public Assistance Benefits	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee
Alternative Minimum Tax				
Repeal	HR 43	Collins	1/7/2003	Referred to the Ways & Means Committee
	HR 1233	English	3/12/2003	Referred to the Ways & Means Committee
	S 1040	Shelby	5/12/2003	Referred to the Senate Finance Committee
	HR 3060	N. Smith	9/10/2003	Referred to the Ways & Means Committee
	HR 4131	Houghton	4/2/2004	Referred to the Ways & Means Committee
	HR 4164	Shuster	4/2/2004	Referred to the Ways & Means Committee
Index AMT exemption	HR 22	Houghton	1/3/2003	Referred to the Ways & Means Committee
Eliminate personal exemptions	HR 1939	Neal	5/1/2003	Referred to the Ways & Means Committee
Tax Preparation and Low Income Taxpayer Clinics				
Matching Grants for LITC for Return Preparation	S 476	Grassley	2/27/2003	Referred to the Senate Finance Committee
	S 685	Bingaman	3/21/2003	Referred to the Senate Finance Committee
	S 882	Baucus	4/10/2003	S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	HR 3983	Becerra	3/17/2004	Referred to the Financial Institutions and Consumer Credit Subcommittee
Regulation of Income Tax Return Preparers	S685	Bingaman	3/21/2003	Referred to the Senate Finance Committee
	S 882	Baucus	4/10/2003	S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)
	HR 3983	Becerra	3/17/2004	Referred to the Financial Institutions and Consumer Credit Subcommittee
Low Income Taxpayer Clinics -- funding & promotion	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	S 882	Baucus	4/10/2003	S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Small Business Issues				
Married Couples as Business Co-owners	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	S 842	Kerry	4/9/2003	Referred to the Senate Finance Committee
	HR 1640	Udall	4/3/2001	Referred to the Ways & Means Committee
	HR 1558	Doggett	4/2/2003	Referred to the Ways & Means Committee
Health Insurance Deduction/Self-Employed Individuals	HR 741	Sanchez	2/12/2003	Referred to the Ways & Means Committee
	HR 1873	Manzull-oVelazquez	4/30/2003	Referred to the Ways & Means Committee
Income Averaging for Commercial Fishermen	**HR 4520**	**Thomas**	**6/4/2004**	**Public Law 108-357 on 10/22/2004**

LEGISLATIVE RECOMMENDATIONS

RECOMMENDATIONS

STATUS OF NATIONAL TAXPAYER ADVOCATE'S LEGISLATIVE RECOMMENDATIONS 108TH CONGRESS

Recommendation	Bill No.	Sponsor	Date	Current Status
Penalties & Interest				
Interest Rate and Failure to Pay Penalty	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Interest Abatement on Erroneous Refunds	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
First Time Penalty Waiver	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Federal Tax Deposit (FTD) Avoidance Penalty	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Office of the National Taxpayer Advocate				
Confidentiality of Taxpayer Communications	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Access to Independent Legal Counsel	HR 1528	Portman	6/20/2003	Referred to the Senate
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
IRS Collection Procedures				
Return of Levy or Sale Proceeds	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Reinstatement of Retirement Accounts	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
	S 882	Baucus	4/10/2003	S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)
Partial Payment Installment Agreements	**HR 4520**	**Thomas**	**6/4/2004**	**Public Law 108-357 on 10/22/2004**
Other Issues				
Disclosure Regarding Suicide Threats	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	S 882	Baucus	4/10/2003	S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Tolling the Statute of Limitations 7811(d)	HR 1528	Portman	6/20/2003	Passed/agreed to in Senate, w/ an amendment (5/19/2004)
	S 882	Baucus	4/10/2003	S.882 was incorporated in H.R. 1528 an amendment and H.R. 1528 passed in lieu of S.882 (May 19, 2004)
	HR 1661	Rangel	4/8/2003	Referred to the Ways & Means Committee
Attorney Fees	**HR 4520**	**Thomas**	**6/4/2004**	**Public Law 108-357 on 10/22/2004**
Attainment of Age Definition	HR 4841	Burns	7/15/2004	Introduced in the House – HR 4841 IH

1 KEY LEGISLATIVE RECOMMENDATION: ALTERNATIVE MINIMUM TAX

PROBLEM

The individual alternative minimum tax (AMT) is a parallel and complex tax structure that is imposed on top of the regular tax structure. While the AMT was originally designed to prevent wealthy taxpayers from escaping tax liability through the use of tax avoidance transactions, it now affects large groups of middle-class taxpayers with no tax avoidance motives at all. For example, many taxpayers are subject to the AMT simply because they have children or live in a high-tax state.

The AMT is ensnaring an ever-growing number of taxpayers because the amount of income exempt from the AMT (the AMT "exemption amount") is not indexed for inflation. When Congress first enacted a minimum tax in 1969, the exemption amount was $30,000 for all taxpayers. If that amount had been indexed, it would be equal to about $153,500 today.[1] Instead, the exemption amount, after a temporary increase that will expire after 2005, is $45,000 for married taxpayers and $33,750 for most other taxpayers.[2] As a result, it is now projected that in 2010, 34.8 million individual taxpayers – or 34 percent of individual filers who pay income tax – will be subject to the AMT.[3] Among the categories of taxpayers hardest hit, 94 percent of married couples with adjusted gross income (AGI) between $75,000 and $100,000 and with two or more children will owe AMT.[4]

The burden that the AMT imposes is substantial. In dollar terms, it has been estimated that the average AMT taxpayer will owe an *additional* $6,000 in tax in 2004.[5] In terms of complexity and time, taxpayers often must complete a 12-line worksheet,[6] read eight pages of instructions,[7] and complete a 55-line form[8] simply to determine whether they are sub-

[1] Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (Nov. 17, 2004). Congress acted after hearing testimony that 155 taxpayers with adjusted gross incomes above $200,000 had paid no federal income tax for the 1966 tax year. See The 1969 Economic Report of the President: Hearings before the Joint Economic Comm., 91st Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury). The consumer price index has more than quintupled since 1966, so the kinds of taxpayers who caught Congress' attention back then would be making over $1.16 million today. *See* Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (Nov. 17, 2004). Yet the AMT today is not primarily affecting taxpayers with incomes over $1.16 million. By 2010, it has been estimated that 83 percent of all taxpayers affected by the AMT will have incomes under $200,000 – and 37 percent will have incomes under $100,000. *See* Leonard E. Burman et al., The Individual Alternative Minimum Tax: A Data Update, table 4 (Aug. 30, 2004) (accessible at 2004 TNT 175-15).

[2] IRC § 55(d).

[3] Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004).

[4] Leonard E. Burman et al., The Individual Alternative Minimum Tax: A Data Update, table 2 (Aug. 30, 2004) (accessible at 2004 TNT 175-15).

[5] Leonard E. Burman et al., The Individual Alternative Minimum Tax: A Data Update, table 3 (Aug. 30, 2004) (accessible at 2004 TNT 175-15).

[6] 2004 Form 1040 Instructions, at 35.

[7] 2004 Form 6251 Instructions.

[8] 2004 Form 6251, Alternative Minimum Tax – Individuals.

ject to the AMT. Thus, it is hardly surprising that 75 percent of AMT taxpayers hire practitioners to prepare their returns.[9]

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

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

EXAMPLES

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

- A mother of five earned $55,000 in 2003. She was separated from her husband during the latter half of the year and thus claimed "married filing separately" filing status. Because of the child tax credit, she had no tax liability under the regular tax rules. She therefore did not have any tax withheld from her paychecks. When she prepared her tax return, however, she discovered that she had a tax liability of $1,760 due to the AMT. Because of the AMT tax liability, she also owed a penalty for failure to pay estimated tax in the amount of $45.
- A taxpayer filed a joint return claiming two exemptions for 2003. The taxpayer had an adjusted gross income (AGI) of $185,000 and paid state income and property taxes totaling $27,000. The taxpayer had 90 percent of his regular tax liability withheld from his paycheck. When the taxpayer prepared his return, he discovered that he had an additional tax liability of $3,908 due to the AMT. Because of the additional AMT tax liability, he also owed a penalty for failure to pay estimated tax in the amount of $101.

[9] Tax Year 2002, IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF).

RECOMMENDATION

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

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

[10] In our 2003 Annual Report to Congress, the National Taxpayer Advocate designated the AMT as the most serious problem facing taxpayers. *See* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), at 5-19. This report was recently cited by the American Bar Association in presenting its recommendation that Congress repeal the individual AMT. *See* Report of the American Bar Association Section of Taxation to the American Bar Association House of Delegates (Aug. 2004) (transmitted with Letter from Kenneth W. Gideon, Chair, American Bar Association Section of Taxation, to Senators Grassley and Baucus and Congressmen Thomas and Rangel (Nov. 29, 2004)). In our 2001 Annual Report to Congress, the National Taxpayer Advocate previously recommended that the AMT be repealed or, at a minimum, that the AMT be substantially revamped to accomplish its original objective of preventing high-income taxpayers from escaping taxation through the use of tax-avoidance techniques. *See* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), at 166-177. The individual AMT and its problems are discussed in more detail in our 2003 and 2001 reports. As a matter of fairness, the repeal of the AMT would require that Congress address the treatment of unused prior-year minimum tax credits, perhaps simply by retaining § 53 of the Code.

2 KEY LEGISLATIVE RECOMMENDATION: SMALL BUSINESS BURDENS

A former IRS Commissioner once called small business the "heart and soul and backbone of America."[1] Numerous statistics support this notion. In 2002 there were nearly 23 million small businesses in the United States.[2] Small businesses provide approximately 75 percent of the net new jobs added to the economy, represent 99.7 percent of all employers, and employ over 50 percent of the private workforce.[3] Small businesses export more than $186 billion a year – about one-third of all U.S. exports by value.[4] In 2001, small firms accounted for more than 44 percent of annual payroll in the United States.[5] In 1999, small businesses created 52 percent of total nonfarm private output.[6] These statistics demonstrate the significant contributions small businesses make to the U.S. economy.

Notwithstanding their substantial contributions to the U.S. economy, small businesses face significant administrative burdens – including tax compliance burdens – that are disproportionate to their individual economic ability to deal with such burdens. A 2001 study by the U.S. Small Business Administration Office of Advocacy found that small firms with fewer than 20 employees pay nearly 60 percent more to comply with Federal regulations than their counterparts with more than 500 employees, and these regulations cost small businesses $6,975 per employee on a yearly basis to administer.[7] Much of this burden is attributable to Federal tax compliance. The Office of Management and Budget reports that approximately 80 percent of all Federal government paperwork burden is attributable to tax

---

1 *Preliminary Transcript of IRS Modernization Conference*, 2000 T.N.T. 24-63, (January 13, 2000) (Statement of Fred. T. Goldberg Jr.).

2 United States Small Business Administration, *Small Business Statistics*, available at http://www.sba.gov/aboutsba/sbastats.html. The IRS defines a small business as a business, including a corporation or a partnership, with assets less than or equal to $10 million. IRM 1.1.16.1(2) (Feb. 1, 2003). The U.S. Census Bureau defines a small business as a business with fewer than 500 employees. *See* United States Small Business Administration, Office of Advocacy, *The Small Business Economy: A Report to the President*, U.S. Government Printing Office, 2004, 172. The U.S. Small Business Administration generally defines a small business as a business with: (1) 500 employees or less for most manufacturing and mining industries; (2) 100 employees or less for wholesale trade industries; (3) assets of $6 million or less for most retail and service industries; (4) assets of $28.5 million for most construction industries; (5) assets of $12 million or less for special trade contractors; or (6) assets of $750,000 or less for most agricultural industries. U.S. Small Business Administration Size Standards, available at http://app1.sba.gov/faqs/faqindex.cfm?areaID=15.

3 United States Small Business Administration, *Small Business Statistics*, available at http://www.sba.gov/aboutsba/sbastats.html.

4 U.S. Chamber of Commerce, *Small Business Platform: Recommendations to the Parties*, 2004, available at http://www.uschamber.com/sb.

5 United States Small Business Administration, Office of Advocacy, *The Small Business Economy: A Report to the President*, U.S. Government Printing Office, 2004, 172.

6 *Id*.

7 W Mark Crain and Thomas D. Hopkins, *The Impact of Regulatory Costs on Small Firms; a report for The Office of Advocacy, U.S. Small Business Administration* (2001), available at http://www.sba.gov/advo/research/rs207tot.pdf.

compliance.[8] In 2000, the Joint Economic Committee reported that small businesses face tax compliance costs that are more than three times larger than taxes paid.[9]

The National Taxpayer Advocate is concerned about tax compliance burdens on small businesses. She has twice testified before Congress on this issue[10] and has made specific recommendations to ease these burdens in each of her prior Annual Reports to Congress.[11] The National Taxpayer Advocate offers the following small business tax compliance burden reduction recommendations in this year's Annual Report to Congress.

8 Office of Management and Budget, Office of Information and Regulatory Affairs, *Managing Information Collection and Dissemination*, Fiscal Year 2003, available at http://www.whitehouse.gov/omb//inforreg/2003_info_coll_dism.pdf.

9 Joint Economic Committee, *Tax Complexity Factbook*, April 1, 2000.

10 The Cost of Regulatory Reform and Overshight: Hearing before the House Committee on Small Business, Subcommittee on Regulatory Reform and Oversight, 108th Cong. (2003), and Assisting Small Business Through the Tax Code, Recent Gains and What Remains to Be Done: Hearing before the House Committee on Small Business, 108th Cong. (2003).

11 National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001, 12-2002 & 12-2003).

HEALTH INSURANCE DEDUCTION FOR SELF-EMPLOYED INDIVIDUALS

PROBLEM

In her 2001 Annual Report to Congress, the National Taxpayer Advocate recommended that Internal Revenue Code § 162(l)(4) be repealed to allow self-employed individuals to deduct the cost of health insurance in computing the net earnings of a sole proprietor from self-employment for self-employment tax purposes.[12] The National Taxpayer Advocate continues to believe that this recommendation has merit because § 162(l)(4) places sole proprietors on unequal ground compared to wage earners.

Many wage earners can participate in benefit plans that allow them to pay for health insurance with pre-tax dollars.[13] These wage earners do not pay income or Social Security tax on their health insurance payments. In contrast, although self-employed individuals can reduce their taxable income by the cost of their health insurance, they must still pay a 15.3 percent self-employment tax on their health insurance costs.[14]

EXAMPLE

> A self-employed individual had a net profit of $50,000 in tax year 2003 before deducting health insurance premiums. This individual paid $3,600 for medical insurance for himself, his wife, and dependent child. The individual may not deduct this expense in computing his net earnings from self-employment (SE). He owes SE tax of $7,065.[15] If the individual were allowed to deduct the medical insurance premiums in computing earnings for SE tax purposes, his SE tax liability would be $6,556[16] – a savings of $509. In contrast, a wage earner who paid $3,600 for health insurance premiums with pre-tax dollars saves $275 in FICA taxes, and his employer saves the same amount.[17]

RECOMMENDATION

Repeal Internal Revenue Code § 162(l)(4).

[12] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), 223. *See also* Self-Employed Health Equity Adjustment to Lower Tax Hindrance Act, H.R. 741, 108th Cong. (2003).

[13] *See* IRC § 125(a) and Prop. Reg. § 1.125-1, Q & A 6.

[14] IRC § 1401.

[15] SE Earnings of $50,000 x 92.35 percent = Net SE earnings of $46,175 x SE Tax Rate of 15.3 percent = $7,065 SE Tax liability.

[16] SE Earnings of $46,400 x 92.35 percent = Net SE earnings of $42,850 x SE Tax Rate of 15.3 percent = $6,556 SE Tax liability.

[17] $3,600 x Employee share of FICA (7.65%) = $275. $3,600 x Employer's share of FICA (7.65 percent = $275. Total savings = $550.

PRESENT LAW

Internal Revenue Code § 1401 imposes a 15.3 percent tax on the self-employment income of every individual, in addition to other taxes. Section 1402(a) sets forth the rules for computing net earnings from self-employment. Generally, net earnings from self-employment means "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by [subtitle A of the Internal Revenue Code] which are attributable to such trade or business. . . ."[18]

Section 162(l)(1) allows an individual who is an employee[19] to deduct the amount paid during the taxable year for health insurance for the employee and for his or her spouse and dependents. Section 162(l)(4), however, does not allow a self-employed individual to deduct payments for health insurance for purposes of determining an individual's net earnings from self-employment as defined in § 1402(a).

Internal Revenue Code § 125(a) provides that, with certain exceptions, benefits received by participants in a cafeteria plan shall not be included in the participant's gross income. Section 125(d) defines a cafeteria plan as a written plan under which all participants are employees and the participants may chose among two or more benefits consisting of cash or qualified benefits. Proposed Treasury Regulation 1.125-1, Q & A 5 indicates that a cafeteria plan may offer participants coverage under a health plan. Proposed Treasury Regulation 1.125-1, Q & A 6 indicates that an employer contribution under a cafeteria plan includes an employee salary reduction that is applied to "purchase" benefits under the plan.[20]

REASONS FOR CHANGE

Internal Revenue Code § 162(1)(4) denies self-employed individuals a tax benefit enjoyed by similarly situated workers who are classified as employees and participate in an employer's cafeteria plan. Under current law, workers classified as employees who participate in a cafeteria plan can pay their personal and family health insurance expenses with pre-tax dollars that are not subject to income or Social Security taxes. On the other hand, similarly situated self-employed workers are subject to SE taxes on personal and family health insurance costs.

EXPLANATION OF RECOMMENDATION

Repealing § 162(1)(4) would give self-employed workers equal standing with workers classified as employees with respect to health insurance expenses, effectively allowing workers to pay these expenses with pre-tax dollars whether classified as employed or self-employed.

[18] IRC § 1402(a).

[19] As defined in IRC § 401(c)(1).

[20] Provided the employer contributions have not been actually or constructively received by the participant.

ELECTION TO BE TREATED AS AN S CORPORATION[21]

PROBLEM

Small business corporations may elect to be treated as a flow-through entity by making an election to be treated as an S corporation, which must be made on or before the 15th day of the third month of the tax year. As a result, taxpayers who wait until the tax return filing date to make this election will be deemed to have made the election for the succeeding year (unless the Secretary determines that there was reasonable cause for the failure to make a timely election). Many small business corporations inadvertently subject themselves to taxation as a C corporation for at least one additional year.

EXAMPLE

Taxpayer is a small advertising business incorporated on January 1, 2003, that uses a calendar year for tax purposes. Taxpayer is owned by individuals A and B. Unless it elects otherwise, Taxpayer will be classified by default as a Subchapter C corporation for Federal tax purposes. In February 2003, A and B decide to operate Taxpayer as an S corporation to avoid the double taxation of corporate profits, and approve a corporate resolution to that effect. Because of miscommunication, Taxpayer fails to file Form 2553, Election by a Small Business Corporation, by March 15, 2003, which is required to be filed by that date for an effective S election for its 2003 taxable year. Taxpayer discovers this oversight in July 2004 and files a Form 2553 at that time. Taxpayer timely files a Form 1120S, U.S. Income Tax Return for an S Corporation, for its 2003 taxable year. This results in:

- An unpostable filed Form 1120S. The IRS converts the Form 1120S to, and posts it as, a Form 1120, U.S. Corporation Income Tax Return, thereby classifying Taxpayer as a C corporation and assessing income taxes at the corporate level, creating the potential for taxation of dividend income at the shareholder level, and preventing A and B from deducting any of Taxpayer's operating losses on their individual returns.
- The flow-through returns related to the Form 1120S may or may not be corrected to reflect the corporate income tax assessment.
- IRS notifies the small business corporation of its changed status and grants the corporation two options:
    1. if the election was in fact approved by the Service – provide proof of filing and approval notification; or
    2. if there is a reasonable cause for late filing – prepare a request for the IRS to treat the late election as timely under Private Letter Ruling (PLR) procedures[22] or the simplified procedures allowed in certain circumstances.[23]

---

[21] *See also* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), 246.

[22] *See generally* Rev. Proc. 2004-1, 2004-1 I.R.B. 1.

[23] *See* Rev. Proc. 2004-48, 2004-32 I.R.B. 172; Rev. Proc. 2003-43, 2003-1 C.B. 998; and Rev. Proc. 97-48, 1997-2 C.B. 521.

[24] *See* IRC §§ 1368(c) and 1371.

- The corporation will not be treated as an S corporation until the 2004 tax year and may carry on certain C corporation attributes such as retained earnings that will be taxable to A and B upon distribution, or net losses that cannot be carried forward to offset future S corporation income.[24]

RECOMMENDATION

Amend Internal Revenue Code § 1362(b)(1) to allow a small business corporation to elect to be treated as an S corporation no later than the date it timely files (including extensions) its first Form 1120S, U.S. Income Tax Return for an S Corporation.

PRESENT LAW

The term "S corporation" means a small business corporation for which an election under § 1362(a) is in effect for such year.[25] The term "small business corporation" means a domestic corporation which is not an ineligible corporation[26] and which does not–

(1) have more than 75 shareholders,

(2) have as a shareholder a person who is not an individual,[27]

(3) have a nonresident alien as a shareholder, and

(4) have more than one class of stock.[28]

A small business corporation may elect to be an S corporation by filing a completed Form 2553, Election by a Small Business Corporation, with the service center designated in the instructions applicable to Form 2553.[29] An election shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.[30]

Internal Revenue Code § 1362(b)(1)(B) requires that the election to be treated as an S corporation be made on or before the 15th day of the third month of the tax year. If this election is not made by the statutory date, it is deemed made for the succeeding year.[31] But under § 1362(b)(5), a taxpayer's late subchapter S election may be treated as timely if

[25] IRC § 1361(a)(1).

[26] Ineligible corporations are: (A) certain financial institutions; (B) insurance companies; (C) corporations that have elected into the Puerto Rico tax credit under IRC § 936; and (D) current or former "Domestic International Sales Corporations." IRC § 1361(b)(2).

[27] Other than an estate, certain trusts, or certain tax exempt organizations. *See* IRC § 1361(a)(1)(B).

[28] IRC § 1361(b)(1).

[29] Treas. Reg. § 1.1362-6.

[30] IRC § 1362(a)(2).

[31] IRC § 1362(b)(3).

the Secretary determines that there was reasonable cause for the failure to make a timely election. However, "reasonable cause" for purposes of § 1362(b)(5) is not defined in the Internal Revenue Code, Treasury Regulations, IRS rulings, procedures or announcements, or even in the Internal Revenue Manual. Moreover, a review of PLRs granting relief under § 1362(b)(5) did not yield any specific factors that the IRS considers in determining if the taxpayer demonstrated reasonable cause for failing to file a timely subchapter S election.

In order to request relief for a late subchapter S election by PLR request, a taxpayer must complete a request for ruling to the IRS Office of Chief Counsel following the procedures set forth in Rev. Proc. 2004-1, which include submitting:

- A $6,000 user fee.
- A complete statement facts and analysis relating to the late election.
- Copies of all relevant documents relating to the late election, such as incorporation documents, shareholder agreements, board minutes showing the intent to file a subchapter S election, etc.
- Several procedural statements and declarations (such as whether the taxpayer has included the relevant issue in prior returns or previously requested a ruling on the issue).
- A statement containing legal authorities supporting the taxpayer's view and any opposing legal authorities.
- A statement identifying any relevant pending legislation.
- A "deletions statement," including a copy of the request showing the taxpayer's desired deletions.
- A signed statement that all information in the request is accurate, under penalties of perjury.
- If the taxpayer is represented, a signed Form 2848, Power of Attorney and Declaration of Representative.

Under the simplified procedures for requesting relief for a late election under Code § 1362(b)(5), neither a PLR request nor user fee is required, but the taxpayer must complete other requirements. For instance, under one of the simplified procedures, the taxpayer must submit to the IRS:

- A statement to the IRS establishing reasonable cause for the failure to file a timely election.
- Statements by all shareholders that they have reported their income consistent with treating the taxpayer as an S corporation for the year of intended election and all subsequent years.

- A completed Form 2553.
- A declaration signed by an authorized officer of the taxpayer stating that the facts presented in support of the election are true, under penalties of perjury.[32]

REASONS FOR CHANGE

Corporations that can file an election to be treated as an S corporation are, by definition, small corporations (i.e., 75 or fewer shareholders).[33] Many small business owners may not have the tax expertise to be aware of the S election filing requirements. Moreover, many small business owners do not have the funds at start-up to afford more than the most rudimentary tax advice. They may even incorporate themselves, using various software packages or forms from state corporation offices. Further, small business owners may not be able to determine the best tax treatment for the business until after the close of the tax year, at the time of filing the first tax return when they actually consult with a tax professional. Anecdotal evidence suggests that many would-be S corporations first become aware of the S election requirement during the preparation of their first tax return, which is typically at least a year beyond the statutory filing deadline.

Although the procedures described above are available to cure a late S election, taxpayers must still incur the time and expense of requesting relief via PLR or the simplified procedures (which can also require substantial time). Even in these instances, the taxpayers must demonstrate reasonable cause for having missed the election. The lack of published guidance on what constitutes reasonable cause for failing to file a timely subchapter S election, however, creates uncertainty. Taxpayers effectively request late S election relief at their own risk. Moreover, the IRS must also use valuable resources to respond to these requests and unwind the taxpayer's first year tax account. A late S election due to a reasonable oversight could also potentially cause unintended consequences to the taxpayer and its owners.[34]

EXPLANATION OF RECOMMENDATIONS

The National Taxpayer Advocate recommends that IRC § 1362(b)(1) be amended to allow small business corporations to make an election to be treated as an S corporation at any time on or before the due date (including extensions) of the tax return for the taxable year for which the election is to be effective. This proposal would still permit a taxpayer to make a valid election as soon as it is incorporated or otherwise formed, while eliminating the drastic consequences and additional curative efforts necessary for late filed elections in the first year of operations.

[32] Rev. Proc. 2003-43.

[33] IRC § 1361(b)(1).

[34] *See* IRC § 1362(b)(3).

PROTECTION FROM PAYROLL SERVICE PROVIDER MISAPPROPRIATION[35]

PROBLEM

The payroll processing industry provides a valuable service to both businesses and federal, state and local taxing authorities by facilitating payroll tax processing and collection. Payroll processing firms, or "payroll agents," provide payroll and employment tax administration services for approximately 20 percent of all U.S. employers, covering one-third of the private sector work force.[36] Payroll agents also transmit over $500 billion annually in employment and income taxes to the federal government – approximately 25 percent of the federal government's annual receipts.[37]

Payroll agents greatly assist businesses with federal, state and local payroll tax requirements by allowing businesses to outsource the burdensome task of payroll tax compliance and focus their resources instead on running and improving their business. Payroll agent services are particularly valuable to small businesses. Payroll and employment tax requirements are complex and payroll processing and employment tax compliance require substantial time and resources.[38] Because small business taxpayers are the least equipped to deal with the complexities of the various federal, state and local payroll tax systems, they benefit the most from the services that payroll agents provide.

Recent events, however, demonstrate that there is some need for taxpayer consumer protection in the payroll service industry – particularly relating to small business taxpayers that use the services of smaller payroll agents. In recent months, there have been several instances of smaller payroll agents collecting payroll taxes from their customers, but failing to transfer these funds to the IRS (and to state and local tax authorities). Compounding the problem, the payroll agent then goes out of business without leaving sufficient cash or other assets to satisfy its customers' employment tax liabilities. In some of these cases, the payroll agent's principals abscond with their customers' employment tax deposit funds.[39]

These cases can place significant burdens on taxpayers who fall victim to these situations. The IRS generally cannot collect the outstanding employment taxes from the payroll agent or its principals because assets are unavailable. The taxpayer, however, remains liable for the outstanding taxes that were never transferred to the IRS. The taxpayer is

[35] *See also*, H.R. 1528, 108th Cong. (2004)

[36] National Payroll Reporting Consortium, information re: HR 1528, The Tax Administration Good Government Act.

[37] *Id.*

[38] *See* section on Federal Tax Deposit Penalties, *infra*.

[39] *See* example, Edward T. Murphy, *Collapse of Payroll Firm May Cost Southern Maine Businesses Millions in Taxes*, Portland Press Herald, Dec. 3, 2003; Dana Hedgpeth, *Past-Due Taxes Stun Companies; Customers Blame Defunct Payroll Firm for Thousands Owed*, Washington Post, May 22, 2003; *Businesses claim payroll service kept money meant for the IRS*, Associated Press, Apr. 26, 2004; Timothy O'Connor, *Man Admits He Stole Payroll Taxes*, The Journal News, Dec. 9, 2004.

thus forced to effectively pay its employment taxes twice: once to the payroll agent, and again to the IRS. And because the IRS did not receive the payroll taxes when due, the taxpayer may also be liable for interest and penalties. This problem can have a significant impact on a small business because very few small businesses have the cash flow to make "double" tax payments.

EXAMPLE:

A taxpayer hires the XYZ payroll service provider to administer its payroll, collect payroll taxes and file applicable IRS forms. XYZ collects payroll tax deposits from the taxpayer, but does not turn these funds over to the IRS. XYZ also changes the taxpayer's mailing address on file with the IRS to XYZ's business address without the taxpayer's knowledge. Thus, when the IRS sends delinquent payroll tax notices to the taxpayer, XYZ receives them and does not turn them over to the taxpayer. XYZ's owner takes the funds deposited by the taxpayer and XYZ's other clients and disappears to the Cayman Islands. Lacking sufficient assets to function as a going concern, XYZ declares bankruptcy. After XYZ goes out of business, the taxpayer discovers that none of its payroll taxes collected by XYZ were deposited with the IRS and that the taxpayer is now liable for delinquent payroll taxes, interest and penalties.

RECOMMENDATIONS

- Amend Internal Revenue Code § 6671(6) to include "payroll agents" within the definition of a "person" subject to the penalty imposed by Internal Revenue Code § 6672(a).
- Amend the Internal Revenue Code to define a "payroll agent" as any person that provides payroll tax deposit services and has the authority to access an employer client's funds for the purpose of making federal payroll tax deposits.
- Amend the United States Bankruptcy Code[40] to clarify that IRC § 6672 penalties survive bankruptcy, even when the debtor is not an individual.
- Amend the Internal Revenue Code to authorize the Secretary of the Treasury to promulgate regulations that require payroll agents to: (1) register with the IRS; and (2) post a bond with the IRS.

PRESENT LAW

Employers are required to collect and deposit both their share and their employees' share of employment taxes and deposit these taxes in an authorized government depository.[41]

[40] Title 11, U.S. Code.

[41] *See* IRC §§ 3102(a) and 3111 (concerning FICA taxes); 3301 (concerning FUTA taxes); 3402(a) (concerning income tax withholding); and 6302 (concerning deposit requirements).

[42] IRC §§ 3402(a) and 3111.

Generally, employment taxes consist of withheld income taxes,[42] Federal Insurance Contributions Act (FICA) taxes,[43] and Federal Unemployment Tax Act (FUTA) taxes.[44] Employers are responsible for withholding and depositing income and FICA taxes from their employees.[45] Employers are also responsible for paying their own share of FICA taxes,[46] and for paying FUTA taxes.[47] Employers who fail to collect and deposit these taxes timely and in the manner prescribed are subject to penalties ranging from two percent to 15 percent of the amount of underpayment.[48]

Internal Revenue Code § 6672(a) provides that:

> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

This penalty is sometimes called the "100 percent" penalty because a taxpayer upon which it is imposed must pay the entire amount of tax that it was required to collect and pay.

Internal Revenue Code § 6671(b) provides that a "person" for purposes of section 6672 includes "an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs." A "person" for purposes of § 6671(b) includes employees, officers, and members of both payroll agent firms and the firms' taxpayer clients. This definition of "person", however, does not include business entities that are treated separately from their principals for federal tax purposes.[49] In other words, under current law, the § 6672 penalty applies to individuals only and not to any business entity.[50]

Thus, in the case of a responsible person required to collect and "pay over" payroll taxes to the IRS who willfully fails to do so (or truthfully account for and pay over such taxes), the § 6672 penalty would apply to all payroll taxes that the responsible person was required to collect and deposit with the IRS. These responsible persons are jointly and severally liable for the § 6672 penalty. In other words, adding another responsible person

[43] IRC § 3102(a).

[44] IRC § 3301.

[45] IRC §§ 3402(a), 3102(a) and 6302.

[46] IRC §§ 3111 and 6302.

[47] IRC §§ 3301 and 6302.

[48] IRC §§ 6656(a). *See also* Federal Tax Deposit Penalties recommendation, *infra*, and National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), 222.

[49] Hereinafter, a "person" for purposes of IRC § 6671(b) will be referred to as a "responsible person."

[50] Unless the entity is disregarded as separate from its owner for federal tax purposes under Treas. Reg. § 301.7701-3.

for § 6672 purposes does not relieve other responsible persons of their liability under § 6672; it instead increases the number of persons liable for the penalties, and ostensibly increases the pool of available assets from which the IRS could collect the penalty.

Section 6672 requires that a responsible person is liable for the total amount of tax the person has evaded, not collected, or not accounted for and paid over. Thus, the amount of the § 6672 penalty depends on the amount of tax the responsible person was required collect, account for and pay over. For instance, if a responsible person is an employer, that person would be liable for withheld employee income taxes and the employee's share of FICA taxes.

Neither the Internal Revenue Code nor the Treasury Regulations currently requires payroll agents to register with the IRS or Department of the Treasury or to be bonded.

11 U.S.C. § 523(a)(1) provides that bankruptcy does not discharge an individual debtor from taxes given priority under 11 U.S.C. § 507(a)(8). 11 U.S.C. § 507(a)(8)(C) provides that "a tax required to be collected or withheld and for which the debtor is liable in whatever capacity" is given eighth priority in bankruptcy. The legislative history of 11 U.S.C. § 507 explains that Internal Revenue Code § 6672 penalties are considered to be taxes given priority in bankruptcy.[51] Courts have also "universally characterized" debts incurred under Internal Revenue Code § 6672 as priority taxes in bankruptcy.[52]

REASONS FOR CHANGE

Recent cases of payroll agent misappropriations and fraud have adversely affected numerous small business taxpayers. Three highly publicized cases in Maine, Ohio, and Maryland involved thousands of taxpayers and millions of dollars in Federal payroll tax liabilities that the taxpayers paid over to the payroll agents but the IRS never received.[53] The Maryland case alone impacted at least 2,000 small business or self-employed taxpayers with combined employment tax liabilities of over $34 million.[54] These taxpayers now find themselves in a situation of having to "double pay" their payroll taxes.

In these recent cases, the IRS has been willing to abate penalties assessed for employment tax deficiencies attributable to payroll agent fraud on a case by case basis. To receive penalty abatement, an affected taxpayer must demonstrate that the deficiency was due to payroll agent fraud by presenting documentation such as bank and payroll records.[55] The IRS has not been willing, however, to abate any underlying employment tax liabilities or

[51] S. 2266, 95th Cong., 2d Sess., as reported by the Senate Judiciary Committee and the Senate Finance Committee (1978)

[52] *In re Coleman*, 19 B.R. 529, 530 (D. Kan. 1982). *See also*, *United States v. Sotelo*, 436 U.S. 268, 275 (1978).

[53] *See* news sources cited in note 39 above.

[54] TAS memo re: First Pay case.

[55] IRS Small Business/Self-Employed Division memorandum re: First Pay case, June 12, 2003.

interest attributable to these liabilities.[56] This is because the Internal Revenue Code currently provides no mechanism to relieve these innocent taxpayers of their unpaid employment tax liabilities.[57]

The tax system has an interest in taking the steps necessary to protect taxpayers from finding themselves in this situation for at least two reasons. First, this problem primarily affects small businesses. Few businesses have the cash flow sufficient to pay taxes twice, in addition to interest and penalties. The tax compliance burdens this problem imposes on a small business may even be substantial enough to jeopardize its future as a going concern.

Second, like return preparers, payroll agents have a fiduciary duty not only to their clients, but to the tax system itself. These payroll agents are, in fact, profiting from obligations imposed on taxpayers by the tax system. Thus, the government has some interest in ensuring that payroll agents faithfully discharge this fiduciary duty.

EXPLANATION OF RECOMMENDATIONS

The National Taxpayer Advocate's recommendations would take several steps toward serving both the government's and taxpayers' interests in providing protection to the small business taxpayers who use payroll agents and preventing payroll agent's from profiting by abusing the tax system:

First, the imposition of the § 6672 penalty to payroll agent firms themselves would increase the number of responsible persons jointly and severally liable for the penalty and also increase the pool of assets available from which the IRS could collect the penalty. Increasing the number of responsible persons and the asset pool would help protect taxpayers that have fallen victim to payroll agent misappropriation by reducing the likelihood that the IRS would need to reach their assets to collect the penalty.

Second, payroll agents should be deemed to be responsible persons under § 6672. The term "payroll agent" should be defined as: any person that provides payroll tax deposit services and who has the authority to access an employer client's funds for the purpose of making federal payroll tax deposits. This would make payroll agents liable not only for their client's withheld employee income and FICA taxes, but also for their client's employer share of FICA taxes and FUTA taxes. Payroll agents would be liable for these employer taxes because § 6672 applies to the taxes "evaded, or not collected, or not accounted for and paid over." The proposed definition of payroll agent would impose a statutory duty on these payroll agents to collect, account and pay over both the employee and employer share of its clients' payroll taxes. Thus, § 6672 would operate to make a

[56] The IRS abated interest in only one payroll fraud case that was worked by TAS.

[57] The National Taxpayer Advocate believes that the IRS has the authority, under IRC § 7122, to compromise these liabilities on the basis of equity and public policy considerations. The IRS, however, takes a very narrow approach to its authority under that provision. *See* Key Legislative Recommendation, Offer in Compromise: Effective Tax Administration, *infra.*

payroll agent liable for all of its client's employment taxes should the payroll agent fail to pay these taxes over to the IRS. This would provide protection for taxpayers using payroll agents because the agents would remain liable for all taxes collected from its client – not just the employee portion.

Third, specifically providing that § 6672 penalties survive bankruptcy would essentially codify the Bankruptcy Code's legislative history and current case law. It would also clarify that § 6672 penalties are not discharged in bankruptcy with respect to responsible persons who are entities as well as those who are individuals. This clarification would further protect taxpayers that use payroll agents that fail to pay over taxes to the IRS and then declare bankruptcy.

Finally, payroll agents should be required to register with the IRS and certify that they have obtained appropriate bonding. Registration will assist taxpayers in verifying that their payroll firms have met minimal soundness requirements, and bonding will give taxpayers the assurance that a surety company has performed the due diligence required to issue a bond. The Secretary should also be authorized to impose monetary penalties on payroll agents for failure to register or obtain requisite bonding, absent reasonable cause.[58]

[58] Conversely, the Secretary may also be authorized to waive the bonding requirement for payroll agents that meet certain high fiduciary standards.

PAYROLL DEPOSIT TAX PENALTIES[59]

PROBLEM:

Internal Revenue Code § 6656 imposes a penalty on employers who fail to deposit employment taxes (*i.e.*, withheld income taxes, Federal Insurance Contributions Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes) within the time and in the proper manner described in § 6302 and the applicable regulations, unless the taxpayer can show that the failure was due to reasonable cause and not due to willful neglect. This Federal Tax Deposit (FTD) penalty ranges from two percent to ten percent of the underpayment, depending on how late the required deposit is.[60] The FTD rules and regulations are complicated; and this complexity can cause taxpayers to be subject to five or ten percent FTD penalties for failing to make deposits in the required manner, even when their deposits are made timely and they are making an honest attempt to comply with the complex deposit rules.

EXAMPLE

> An employer ran out of federal tax deposit coupons and was unable to make a deposit at his bank. The employer hand-delivered the required deposit of $2,000 to the local IRS office on the day it was due. The IRS assessed a ten percent FTD penalty because the employer failed to make the deposit through its bank, the authorized depository.

RECOMMENDATION

Amend Internal Revenue Code § 6656 to clarify that: (1) the reasonable cause exception to the FTD penalty shall specifically apply to instances where a taxpayer has made a timely deposit, but failed to make the deposit in the prescribed manner and such failure was not due to willful neglect; and (2) in no circumstance shall the FTD penalty exceed two percent of the underpayment amount when a taxpayer has made a timely deposit, but failed only to make the deposit in the prescribed manner.

Amending § 6656 to specifically apply the reasonable cause exception to the FTD penalty to instances where a taxpayer has made a timely deposit, but failed to make the deposit in the prescribed manner (and such failure was not due to willful neglect), and to cap the FTD penalty at two percent of the underpayment amount when a taxpayer has made a timely deposit but failed to do so in the prescribed manner would eliminate or reduce penalties on taxpayers who have demonstrated a reasonable attempt to comply with the complicated FTD rules. Amending § 6656 in this manner would also reduce administrative burden on both taxpayers and the IRS by avoiding FTD penalty controversies and subsequent abatements when the taxpayer can show its failure to make the required deposit in the prescribed manner was due to reasonable cause.

[59] *See also* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001) 222 and H.R. 1528, 108th Cong. (2004).

[60] The FTD penalty is two percent if the failure to deposit is for not more than five days; five percent if the failure is for more than five days but not more than fifteen days; and ten percent if the failure is for more than fifteen days. IRC § 6656(b)(1).

MARRIED COUPLES AS BUSINESS CO-OWNERS[61]

PROBLEM

An unincorporated business jointly owned by a married couple is classified by default as a partnership for federal income tax purposes.[62] As such, the business is subject to complex record-keeping requirements and must file a partnership income tax return (Form 1065, U.S. Return of Partnership Income).[63]

Notwithstanding that many husband-and-wife-owned businesses are required to file partnership tax returns, there is compelling anecdotal evidence that many do not. Instead, they report the results of their business operations on the less complex Form 1040, Schedule C, Profit or Loss from Business (Sole Proprietorship). By statute, these businesses and/or their owners are subject to penalties for failing to comply with the partnership tax return requirements.

A couple's decision to file a Schedule C in lieu of a partnership tax return can also have nontax ramifications. If married co-owners of a business file a single Schedule C, they must report all income from the business under the name of one spouse. Because the husband and wife are self-employed, they must also complete a Form 1040, Schedule SE (Self-Employment Tax) to report and pay Social Security and Medicare taxes. If all business income is reported on a Schedule C under the name of one spouse, only that spouse can file a Schedule SE and receive credit for paying into the Social Security and Medicare systems. Reporting all income under the name of one spouse may lead to unintended consequences, including:

- **Inability to Obtain Social Security and Medicare Benefits.** The spouse for whom no earned income is reported (the "ineligible spouse") does not receive credit for paying Social Security or Medicare tax. The ineligible spouse also would not qualify for Medicare benefits.
- **Adverse Consequences upon Divorce.** If the couple had operated the business on a 50/50 basis but reported the business for tax purposes as wholly owned by one spouse, the other spouse would have to prove in a divorce proceeding that the tax return was inaccurate to substantiate his or her interest in the business.

EXAMPLE

A married couple with two young children jointly owns and operates a small dairy farm that is treated as a partnership for federal tax purposes. The wife keeps the

[61] *See also* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), 172 and S. 842 108th Cong. (2003).

[62] Unless the business elects to be treated as an association taxable as a corporation. *See* Treas. Reg. § 301.7701-3(a).

[63] The IRS estimates that it takes an average partnership over 200 hours to complete and file this return and the associated schedules. 2003 Instructions to Form 1065, 31. If one member of this partnership were to treat this task as a full-time job, it would take him or her five weeks of work each year to prepare this return!

books, orders supplies, and coordinates deliveries. The husband takes care of the cows, milks them, and delivers the milk to customers. The couple has reported an average business profit of $40,000 each year for the past 15 years.

Instead of dividing the business income between them on a partnership income tax return and filing two Schedules SE, the couple has chosen to file a Form 1040, Schedule F, Profit or Loss from Farming, and one Schedule SE, Self-Employment Tax, and to report all earnings under the husband's Social Security number. The couple had considered hiring a bookkeeper and using a paid tax preparer, but determined it would be cost-prohibitive to do so.

The wife dies unexpectedly at age 40. Because all contributions to the Social Security system had been made in her husband's name and not her own, the husband and children cannot collect Social Security survivor benefits.

RECOMMENDATIONS

- Amend IRC § 761(a) to allow married couples operating a business as co-owners to elect out of subchapter K of the Code and file one Schedule C and two Schedules SE if –
  1. all of the capital and profits interest in the partnership are owned by two individuals who are married to each other; and
  2. the couple makes an election; and
  3. the couple files a joint return for all taxable years that includes the items of the partnership, provided that the couple maintains adequate records to substantiate their respective interests in the partnership.
- Amend IRC § 6017 to require each spouse who operates an unincorporated business solely with his or her spouse as co-owners to file separate Schedules SE.

The National Taxpayer Advocate recommends that, if this proposal is enacted, the IRS create a Schedule C supplemental form for married co-owners of a business. All income and expenses of the business would be reported on this form, and the businesses' net profit or loss would be allocated between the spouses.

3 KEY LEGISLATIVE RECOMMENDATION: SIMPLIFICATION OF PROVISIONS TO ENCOURAGE EDUCATION

DID YOU KNOW?

- The Internal Revenue Code contains at least nine provisions dealing with education incentives, in the form of credits, deductions, and income exclusions.[1]
- To learn about the various education provisions available, taxpayers need to read the 83-page IRS Publication 970, Tax Benefits for Education.
- To determine whether they qualify for the Hope Scholarship, Lifetime Learning Credit or Deduction for Qualified Tuition and Related Expenses as well as determining which provision is most beneficial, Publication 970 requires taxpayers to read more than 20 pages (including three long flowcharts) and complete three worksheets of varying lengths and one 18-line tax form.[2]
- Of the six education incentives that include phase-out provisions based on income, there are six different income threshold amounts.[3]
- Among the various education provisions, there are four different measures of income to determine whether the taxpayer qualifies to claim the tax benefit.[4]
- Among five provisions that use the term “qualified higher education expenses,” there are three different definitions for that term.[5]
- Two provisions allow for expenses related to primary and secondary as well as post-secondary education. However, each provision defines covered expenses differently.[6]
- An individual can contribute money to a 529 plan to fund the higher education expenses of *anybody*.[7]

[1] IRC §§ 25A, 117, 127, 135, 221, 222, 529,

[2] IRS Publication 970, *Tax Benefits for Education.* Catalog No. 25221V, 9-23, 34-39; Form 8863, Education Credits.

[3] IRC §§ 25A(d), 135(b)(2), 221(b)(2), 222(b)(2), 408A(c)(3)(C), 530(b)(1)(A).

[4] IRC §§ 25A(d)(3), 135(c)(4), 221(b)(2)(C), and 530(c)(2) define "modified adjusted gross income (MAGI) in three different ways. IRC § 222(b)(2)(C) refers to "adjusted gross income" (AGI).

[5] See IRC § 135(c)(2), 221(d)(2), 72(t)(2)(E), 529(e)(3), 530(b)(2)(A).

[6] IRC §§ 117(b)(2)(A), 530(b)(1)(A).

[7] IRC § 529(e)(1).

PROBLEM STATEMENT

The education incentive provisions of the Internal Revenue Code are extremely complex and difficult to navigate. Taxpayers face difficulties just trying to identify the provisions for which they satisfy the initial qualifications. The provisions have different student qualification standards and cover different types of educational expenses. Further, there are inconsistencies with respect to income level requirements, phase-out calculations, and inflationary or cost-of-living adjustments. Finally, the fact that the tax incentives have a variety of expiration dates makes planning very difficult for taxpayers wishing to save for future education costs.

The complexities of these provisions may prevent some taxpayers, especially those who are less financially literate and lack the assistance of knowledgeable financial or tax advisors, from taking advantage of their benefits. This complexity also exposes those taxpayers without skilled tax preparers to a higher risk of errors on their returns.

EXAMPLE

> A single mother of two sons has adjusted gross income of $50,000 in tax year 2004. During the year, she paid a total of $15,000 in college tuition and fees for her children (assume equal amounts are paid for each son). The Hope Scholarship and Lifetime Learning Credits under IRC § 25A will be partially phased out due to her income level. While the Hope Scholarship Credit (HSC) is not available for expenses incurred for her older son because he is not in the first two years of school, the taxpayer is eligible to take the Lifetime Learning Credit (LLC) for these expenses. For the expenses related to the younger son, who is in his first year of college, the taxpayer must determine which IRC § 25A credit is more beneficial. In addition, she must compare the resulting tax benefits of the credits for each son to the potential benefits under the IRC § 222 Deduction for Qualified Tuition and Related Expenses.

RECOMMENDATION

The complexity of the Internal Revenue Code's education provisions imposes a significant burden on taxpayers. Each of the following simplification measures would benefit taxpayers by consolidating, creating uniformity among, or adding permanency to the various provisions:

- The Hope Scholarship Credit and Lifetime Learning Credit under IRC § 25A should be consolidated with the IRC § 222 Deduction for Qualified Tuition and Related Expenses and possibly the IRC § 221 Deduction of Interest on Education Loans.
- The education provisions should be made more consistent regarding the relationship of the student to the taxpayer as well as other qualifying criteria.

- The definitions for "Qualified Higher Education Expenses" and "Eligible Education Institution" should be simplified by creating uniformity among the various provisions.
- The income level amounts and phase-out calculations should be more consistent among the applicable provisions.
- All dollar amounts included in the provisions should be uniformly indexed for inflation.
- After the initial use of sunset provisions to test the education incentives and any associated simplification amendments, the incentives should be made permanent.

The IRS must also conduct education campaigns to inform taxpayers, practitioners, and other education stakeholders of any changes made to these provisions.

PRESENT LAW

Education incentives are included in the Internal Revenue Code as credits, deductions, and exclusions from income. The following discussion will briefly summarize the various provisions that offer education incentives.

Tax Credits: IRC § 25A, Hope Scholarship and Lifetime Learning Credits

Internal Revenue Code § 25A sets forth two nonrefundable tax credits: the Hope Scholarship Credit (HSC) and Lifetime Learning Credit (LLC).[8] A taxpayer can claim both during the same tax year as long as the underlying expenses for each credit are not incurred for the same student.[9] Either credit is available to taxpayers with modified adjusted gross income (MAGI)[10] of up to $40,000 ($80,000 for married taxpayers filing jointly), as adjusted for inflation.[11] The student must be the taxpayer, the taxpayer's spouse or the taxpayer's dependent, and attend an "eligible education institution."[12] Once the taxpayer's MAGI reaches the income threshold amount, the allowable credit amounts are gradually phased out until the taxpayer's MAGI exceeds the income thresholds by $10,000, at which point the credit is completely phased out.[13]

8 In tax year 2002, approximately 6.5 million individual taxpayers filed income tax returns reporting education tax credits (HSC and LLC) totaling approximately $4.9 billion (averaging approximately $756 per return). IRS, Individual Income Tax Returns, Preliminary Data, 2002.

9 IRC §25A(c)(2)(A).

10 MAGI is defined differently among the various provisions, as discussed below. For purposes of IRC § 25A, MAGI is defined as adjusted gross income (AGI) increased by any amount excluded from gross income under IRC § 911 (foreign earned income and housing costs of U.S. residents living abroad), IRC § 931 (income from sources within Guam, American Samoa, or the Northern Mariana Islands), and IRC § 933 (income from sources within Puerto Rico). IRC § 25A(d)(3

11 IRC § 25A(d). In 2004, the adjusted amounts equal $42,000 and $85,000, respectively. IRS Publication 970, *Tax Benefits for Education.* Catalog No. 25221V, 74.

12 An eligible education institution is an institution which is described in § 481 of the Higher Education Act of 1965, 20 U.S.C. 1088. IRC § 25A(f).

13 IRC § 25A(d)(2).

The HSC is a nonrefundable credit computed on a *per student* basis and only covers the first two years of study at an institution of higher education.[14] The HSC is limited to $1,000 of qualified tuition and related expenses and 50 percent of the next $1,000 of such expenses (resulting in a maximum credit of $1,500), as adjusted for inflation.[15]

Unlike the HSC, the LLC is a *per return* nonrefundable credit. It is limited to 20 percent of up to $10,000 of qualified tuition and related expenses incurred (resulting in a maximum credit of $2,000).[16]

Tax Deductions

IRC § 221: Deduction for Interest on Education Loans

Internal Revenue Code § 221 provides for an above-the-line deduction of a maximum of $2,500 (not indexed for inflation) of interest paid on any qualified education loan.[17] The amount of the deduction is gradually phased out once the taxpayer's MAGI exceeds $50,000 ($100,000 for married taxpayers filing jointly), as adjusted for inflation.[18] The underlying expenses must be for "qualified higher education expenses" incurred in connection with attendance of the taxpayer, the taxpayer's spouse or dependent at an "eligible education institution."[19]

IRC § 222: Deduction for Qualified Tuition and Related Expenses

Internal Revenue Code § 222 provides for an above-the-line deduction for up to the "qualified tuition and related expenses" incurred by the taxpayer, taxpayer's spouse or dependent at an "eligible education institution."[20] In 2004 and 2005, the deduction is limited to $4,000 (not adjusted for inflation) for taxpayers with adjusted gross income (AGI) not exceeding $65,000 ($130,000 for married taxpayers filing jointly). The deduction falls to $2,000 for taxpayers with AGI not exceeding $80,000 ($160,000 for married taxpayers filing jointly). The income thresholds are not adjusted for inflation[21] and the provision sunsets after December 31, 2005.[22]

[14] The student must attend at least half-time. IRC § 25A(b).

[15] IRC § 25A(h).

[16] IRC § 25A(c).

[17] In tax year 2002, approximately 6.7 million taxpayers claimed the IRC § 221 deduction totaling approximately $4.5 billion (averaging approximately $671 per return). IRS, Individual Income Tax Returns, Preliminary Data, 2002.

[18] IRC §§ 221(b)(2)(B)(i)(II), (f).

[19] IRC §§ 221(d)(1), (2).

[20] IRC § 222(d)(1). In tax year 2002, approximately 3.5 million taxpayers claimed the IRC § 222 deduction totaling approximately $6.2 billion (averaging approximately $1,792 per return). IRS, Individual Income Tax Returns, Preliminary Data, 2002.

[21] IRC § 222(b)(2).

[22] IRC § 222(e).

Income Exclusions

IRC § 117: Exclusion for Qualified Scholarships

Internal Revenue Code § 117 provides for an exclusion from gross income of any amount received by an individual as a qualified scholarship or qualified tuition reduction. The exclusion applies to the amount of a scholarship which covers "qualified tuition and related expenses, related to primary, secondary and post-secondary education."[23] The exclusion also applies to the amount of any reduction in tuition provided to an employee of a primary, secondary or post-secondary school. This provision does not have income level limitations.

IRC § 127: Exclusion for Educational Assistance Programs

Internal Revenue Code § 127 provides for an exclusion from income for amounts paid or incurred by the taxpayer's employer for educational assistance pursuant to an eligible educational assistance program. The maximum exclusion of $5,250 is not adjusted for inflation.[24]

IRC § 135: Exclusion for Income on U.S. Savings Bonds Used to Pay Education Tuition and Fees

Internal Revenue Code § 135 provides for an exclusion of income realized on the redemption of a qualified U.S. savings bond if such income is used to pay for "qualified higher education expenses" incurred by the taxpayer, the taxpayer's spouse or dependent at an "eligible education institution."[25] The exclusion is gradually phased out once the taxpayer's MAGI reaches $40,000 ($60,000 for married taxpayers filing jointly), as adjusted for inflation.[26]

IRC § 408A: Roth IRA Provision[27]

Internal Revenue Code § 408A provides for an exclusion from income of the earnings portion of qualified distributions from Roth IRAs. Early distributions to pay for the "qualified higher education expenses" of the taxpayer, taxpayer's spouse, dependent or grandchild are not considered qualified distributions and are, thus, includible in the taxpayer's gross income. However, such distributions are not subject to the ten percent penalty tax on early distributions.[28] The maximum allowable annual contribution is generally limited to $3,000 in 2004, $4,000 in 2005, and is adjusted for inflation after increasing to $5,000 in 2008. However, the maximum contribution gradually phases out

[23] IRC §§ 117(b)(2), (d)(2).

[24] IRC § 127(a). Also note that IRC § 132(d) provides for an exclusion for job-related educational benefits which qualify as working condition fringe benefits.

[25] IRC § 135(c).

[26] Because the provision is approximately 12 years old, the income thresholds have increased to $59,850 and $89,750, respectively. IRS Publication 970, Tax Benefits for Education for use in preparing 2004 Returns, 56. IRC § 135(b)(2). Further, IRC § 135(c)(4) provides that MAGI is calculated without regard to IRC §§ 911, 931, 933, 137 (adoption assistance), 221, 222 and after application of IRC §§ 86 (social security benefits), 469 (passive activity losses and credits), and 219 (retirement savings).

[27] This discussion focuses on Roth IRAs. However, traditional IRAs also provide an exception to the early penalty tax for distributions made for qualified higher education expenses. IRC §72(t)(2)(E). For further discussion on this topic, see the Key Legislative Recommendation on Retirement Plans Simplification.

[28] IRC §§ 72(t)(2)(E), 72(t)(7).

once the taxpayer's MAGI exceeds $95,000 ($150,000 for taxpayers filing jointly).[29]

IRC § 529: Qualified Tuition Plans

Internal Revenue Code § 529 provides tax-exempt status for qualified tuition programs and tax favored treatment for funds invested on behalf of a designated beneficiary. Contributions to the accounts grow on a tax deferred basis. The provision provides for an exclusion from income for the earnings on distributed funds that are used to pay for the "qualified higher education expenses" of the designated account beneficiary (who may or may not be related to the taxpayer). Contributions are not limited based on income thresholds.[30]

IRC § 530: Coverdell Education Savings Accounts (Coverdell ESAs)

Internal Revenue Code § 530 provides tax-exempt status to certain trusts or custodial accounts that are Coverdell education savings accounts. The provision also provides tax favored treatment for funds invested on behalf of a beneficiary in a Coverdell ESA. Contributions to the account grow on a tax deferred basis. Internal Revenue Code § 530 provides an exclusion from income for earnings on distributed funds that are used to pay for "qualified higher education expenses" or "qualified elementary and secondary expenses" of the designated beneficiary, who need not be related to the contributor. The beneficiary must be under the age of 18 at the time of contribution and the account funds must be distributed when the beneficiary reaches age 30.[31] The maximum annual contribution of $2,000 is gradually phased out after the contributor's MAGI exceeds $95,000 ($190,000 for married taxpayers filing jointly).[32]

REASONS FOR CHANGE

The various education incentives were enacted at different times, with distinct social needs and targeted behaviors in mind. As each provision was drafted, Congress considered the distributional effects of the tax change and attempted to minimize the number of losers as well as avoid creating a disproportionate number of winners.[33] Unfortunately, as each provision became part of the Internal Revenue Code, the inconsistencies between provisions increased. Taxpayers now face a bewildering set of credits and associated rules, leading many taxpayers to struggle in differentiating the provisions, determining eligibility, and trying to understand the confusing relationships between the provisions. Table 2.3.1, located at the end of this discussion, summarizes the various inconsistencies among the provisions, as set forth below.

[29] IRC § 408A(c).

[30] IRC §§ 529(c), (e).

[31] IRC §§ 530(b), (c).

[32] IRC § 530(b)(1)(A).

[33] The Joint Committee on Taxation, Treasury and the Congressional Budget Office produce "tax burden tables" showing the distributional effects of tax changes on taxpayers grouped by income levels. "Losers" refer to the group of taxpayers who pay more taxes as a result of the tax change. "Winners" refer to the group of taxpayers who benefit from the tax change. An example of disproportionate winners is where a tax change would unintentionally result in benefiting one economic class of taxpayers more than any other class.

Eligibility of Student

The various provisions lack consistency regarding the eligibility of the student who actually incurs the educational expenses, and vary with respect to the required relationship between student and taxpayer. For example, some provisions cover the taxpayer, the taxpayer's spouse and the taxpayer's dependents;[34] the Roth IRA covers the aforementioned plus the taxpayer's grandchildren;[35] one provision requires the taxpayer to be the student;[36] and some provisions carry no relationship requirements at all.[37] In addition to these varying standards, some provisions impose attendance or age requirements.[38]

Qualified Education Expenses

The different types of educational expenses qualifying for each tax provision provide an additional source of confusion. Of the provisions that require enrollment in a post-secondary school, some apply to "qualified tuition and related expenses,"[39] while others specify "qualified higher education expenses."[40] Both of these terms require enrollment in an "eligible education institution."[41] Of the two provisions that apply to primary and secondary as well as post-secondary schools, one provision covers "qualified tuition and related expenses"[42] and another covers "qualified education expenses."[43] The provisions also give varying treatment to room and board; expenses for books, supplies and equipment; expenses relating to sports and hobbies; and nonacademic fees.[44] The differences require taxpayers to keep track of certain expenses separately and increase the likelihood of errors.[45]

[34] IRC §§ 25A(f)(1)(A), 135(c)(2)(A), 221(d)(1)(A), 222(d)(1).

[35] IRC §§ 72(t)(2)(E), 7).

[36] IRC §127(a)(1).

[37] IRC §§ 529(c)(3)(C), 530(d)(6).

[38] The HSC in IRC § 25A(b)(2) requires that the student be enrolled in one of the first two years of post-secondary school and never convicted of a felony drug charge. IRC § 530(b)(1) requires that the beneficiary of the Coverdell ESA be younger than age 18 at the time of contribution and that the account funds are completely distributed by the time the beneficiary reaches the age of 30.

[39] IRC §§ 25A(f)(1)(A), 117(b)(2), 222(d)(1).

[40] There are at least three definitions of this "qualified higher education expenses." IRC §§ 135(c)(2), 221(d)(2), 72(t)(2)(E), 529(e)(3), 530(b)(2)(A).

[41] The following provisions define the term as institutions described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088): IRC §§ 25A(f)(2), 135(c)(3), 221(d)(2), 222(d)(1), 529(e)(5) and 530(b)(1)(A).

[42] IRC § 117(b)(2)(A).

[43] IRC § 530(b)(2)(A).

[44] For example, the term "qualified higher education expenses" is defined in IRC § 529(e)(3) to include tuition, fees, books, supplies, equipment required for enrollment or attendance, certain expenses for special needs services, and certain room and board expenses. The term is defined in IRC § 135(c)(2) to only include tuition and fees.

[45] Staff of the Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendation of the State of the Joint Committee on Taxation to Simplify the Federal Tax System, 122-142 (April 2001).

Income Phase-out Calculations and Inflationary Adjustments

Among the most significant inconsistencies between the various provisions are the different income phase-out calculations. While the phase-out formulas are fairly similar,[46] the phase-out ranges[47] and income threshold amounts[48] vary substantially. Further, while most formulas use the taxpayer's modified adjusted gross income (MAGI), the definitions differ,[49] and one provision refers to the taxpayer's adjusted gross income (AGI) rather than MAGI.[50] To compound the complexity of the phase-out calculations, some provisions provide for inflationary adjustments while others do not.[51] The inconsistency with respect to inflation not only leads to confusion but also makes those non-indexed provisions less beneficial as time passes, considering that the costs of college tuition and fees have generally risen by more than twice the economy's overall price level.[52]

Expiration of Provisions

Even if taxpayers and preparers sufficiently understand and navigate the various education incentive provisions, they must also deal with their varying degrees of permanence. For example, the IRC § 222 Deduction for Qualified Tuition and Related Expenses expires after 2005.[53] Many of the tax benefits added to the Code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) will expire after 2010 and revert to pre-

---

[46] The typical phase-out calculation reduces the maximum amount of the credit, deduction or contribution amount by an amount which bears the same ratio to the maximum amount as the excess of the taxpayer's MAGI/AGI over the income threshold amount bears to a preset dollar amount ("the phase-out range"). *See* IRC §§ 25A(d), 135(b)(2), 221(b)(2)(B), 408A(c)(3)(C)(ii), 530(c).

[47] The phase-out range is the difference between the income amount at which point the benefit begins to phase-out and the income amount at which point the benefit is completely phased out. The phase-out range is $10,000 ($20,000 for married taxpayers filing jointly) for IRC § 25A(d). The phase-out range is $15,000 ($30,000 for married taxpayers filing jointly) for most of the provisions, which include IRC §§ 135(b)(2), 221(b)(2)(B), 408A(c)(3)(C), and 530(c).

[48] The income threshold is $40,000 ($80,000 for married taxpayers filing jointly) for IRC § 25A(d); $40,000 ($60,000 joint returns) for IRC § 135(b)(2)(A); $50,000 ($100,000 joint returns) for IRC § 221(b)(2)(B); $65,000 ($130,000 joint returns) and $80,000 ($160,000 joint returns) for IRC § 222(b)(2); $95,000 ($150,000) for IRC § 408A(c)(3)(C); $95,000 ($190,000 joint returns) for IRC § 530(c).

[49] IRC §§ 25A(d)(3) and 530(c)(2) defines MAGI as AGI increased by any amount excluded from gross income under IRC § 911 (foreign earned income and housing costs of U.S. residents living abroad), IRC § 931 (income from sources within Guam, American Samoa, or the Northern Mariana Islands), IRC § 933 (income from sources within Puerto Rico). However IRC § 135(c)(4) provides that MAGI is calculated without regard to IRC §§ 911, 931, 933, 137 (adoption assistance), 221, 222 and after application of IRC §§ 86 (Social Security benefits), 469 (passive activity losses and credits), and 219 (retirement savings). IRC § 221 defines MAGI in a similar manner to IRC § 135, but substitutes IRC §135 for IRC § 221 in the definition.

[50] IRC § 222(b).

[51] Only IRC §§ 25A(h) (referring to the HSC) and 408A(c)(2) provide for inflationary adjustments in the maximum allowable credit or contribution. The following provisions have inflationary adjustments to the income

[52] Staff of the Joint Committee on Taxation, Present Law and Analysis Relating to Tax Benefits for Higher Education, JCX-52-04 (July 21, 2004). For the 2004-05 academic year, the average total costs at four-year public colleges and universities increased by 7.8 percent. Average total costs increased by 5.6 percent for private four-year colleges and universities. College Board, *Trends in College Pricing 2004*, 3.

[53] IRC § 222(e).

EGTRAA rules.[54] These sunset provisions present a particularly significant concern for taxpayers trying to save for future education costs.[55]

Interrelationship of Provisions

Not only are the various provisions individually complex, but they also have interrelationships that taxpayers must navigate. While it is reasonable to assume that most taxpayers would understand they should not claim a double benefit for the same educational expenses, other limitations may not be as obvious.[56] For example, a taxpayer is allowed to take both IRC § 25A credits as long as the HSC and LLC apply to expenses for different students.[57] Similarly, the IRC § 222 Deduction for Qualified Tuition and Related Expenses is completely denied if either credit is taken under IRC § 25A with respect to that student.[58] Some taxpayers may also be unaware that they can roll over their funds to consecutively take advantage of multiple provisions, such as taking the funds from redeemed IRC § 135 U.S. savings bonds and continuing to exclude income generated by such funds by contributing the funds to IRC § 529 plans or Coverdell ESAs.[59]

Effect of Complexities on Taxpayers

The educational incentives in the Internal Revenue Code are important for policy reasons. These provisions encourage taxpayers to pursue education by making it more affordable.[60] In theory, the existence of a variety of tax incentives for education may provide more choices and make the incentives available to more taxpayers. However, many taxpayers find it intimidating to understand the tax benefits provided by the different provisions, the various eligibility requirements, the interactions between different provisions, and the record-keeping and reporting requirements. In addition, taxpayers face complexities inherent in the financial products themselves, such as the choices between investment options, understanding the different fee structures and plan features, and monitoring each product's investment performance.[61]

[54] Some of the affected provisions include the IRC § 221 Deduction for Interest on Education Loans, IRC § 529 Qualified Tuition Programs and IRC § 530 Coverdell ESAs. Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, §§ 901(a)(1), (b) (June 7, 2001).

[55] Statement of Charles Toth on Behalf of the College Savings Foundation and the Securities Industry Association Before the United States Senate Committee on Finance, The Role of Higher Education Financing in Strengthening U.S. Competitiveness in a Global Economy (July 22, 2002), published by Tax Analysts (July 23, 2004).

[56] A taxpayer cannot claim two credits, deductions, exclusions or a combination thereof for the same expenses. *See* IRC §§ 25A(g)(5), 221(e), 222(c), 529(c)(3)(b)(iv), 530(d)(2)(C), and 135(d)(2).

[57] IRC §§ 25A(c)(2)(A).

[58] IRC § 222(c)(2).

[59] IRC § 135(c)(2)(C).

[60] Staff of the Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendation of the State of the Joint Committee on Taxation to Simplify the Federal Tax System, 122 (April 2001).

[61] Staff of the Joint Committee on Taxation, Present Law and Analysis Relating to Tax Benefits for Higher Education, JCX-52-04, 44 (July 21, 2004). *See* Michael A. Olivas, University of Houston Law Center, Institute for Higher Education Law & Governance, Testimony Before the U.S. House of Representatives, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services (June 2, 2004), in Tax Notes Today, 2004 TNT 107-34 (June 3, 2004).

The IRS issues Publication 970, Tax Benefits for Education,[62] to educate taxpayers about the various education incentive provisions. However, the 2004 version of the publication contains over 80 pages of instructions, worksheets, and sample tax return forms for the various educational provisions contained in the Internal Revenue Code. While the publication is extremely useful to taxpayers, it is still likely to be overwhelming for many who are not well-versed in the tax laws.

The complexities of and inconsistencies among the education incentive provisions can easily trip up taxpayers and even preparers, resulting in inadvertent tax return errors.[63] The complexities may also prevent some of the less financially literate taxpayers from receiving the full benefit of the incentives.[64]

EXPLANATION OF RECOMMENDATION

As currently drafted, the education incentive provisions in the Internal Revenue Code are too complex. The following discussion sets forth several suggested methods of simplifying the provisions. Each recommendation should be considered independently, with the potential of adaptation on an individual basis or in combination with a separate simplification measure:

Consolidation of IRC §25A Credits and Deductions under IRC §§ 221 and 222

The Hope Scholarship Credit (HSC) and the Lifetime Learning Credit (LLC) of IRC § 25A should be combined into one credit that can be taken on a per student basis (rather than a per return basis).[65] The provisions could be further simplified by consolidating the combined IRC § 25A credit with the IRC § 222 Deduction for Qualified Tuition and Related Expenses, and potentially with the IRC § 221 Deduction for Interest on Education Loans.[66]

---

[62] IRS Publication 970, *Tax Benefits for Education for use in preparing 2004 Returns*, Catalog No. 25221V.

[63] Analysis of Taxpayer Advocate Service cases on the Taxpayer Advocate Management Information System (TAMIS) between October 2003 and August 2004 found 44 cases involving education incentive related issues. Thirty-six cases involved IRC § 25A issues, with the main issues involving the failure to claim such claims (15 cases) and credit computation errors (13 cases). In addition, four cases involved the failure to take the IRC § 221 deduction. An additional four cases involved IRC § 117 scholarship issues and one case involved the failure to take the IRC § 222 deduction for tuition and expenses. Of the cases where the taxpayers failed to take advantage of an education incentive provision, the taxpayer claimed to be unaware of the provision. W&I worked 754 audits and assessed $416,849 related to IRC § 529 and IRC § 221. Further, W&I started 1,713 audits, closed 1,887 audits and assessed $1,202,486 on audits related to the § 25A credits. W&I Response to Taxpayer Advocate Service Information Request (Sept. 8, 2004).

[64] Department of Treasury, Press Release, Testimony of Pamela F. Olson, Assistant Secretary (Tax Policy), United States Department of Treasury, Before the Committee on Ways and Means, United States House of Representatives, JS-1167, 4 (Feb. 12, 2004) ("Lower income individuals … tend not to have access to the sophisticated advice needed to navigate the complex, and often conflicting, rules that govern the existing savings vehicles."); Letter from Gregory F. Jenner to Representative Frank R. Wolf, U.S. House of Representatives (March 30, 2004); ("[I]ndividuals often fail to contribute to an IRA even in those instances where the taxpayer is eligible to make a contribution because the complexity of making a determination of eligibility is so daunting.").

[65] For examples of similar proposals, see American Bar Association Section of Taxation, AICPA Tax Division, and the Tax Executives Institute, Tax Simplification Recommendations, 7 (Feb. 2001) (generally recommending that the IRC § 25A credits are combined); and the Education Tax Credit Simplification Act of 2004 in H.R. 4136, which was introduced by Representative Amo Houghton. Specifically, § 2(a) of H.R. 4136, provides for one "education credit" in IRC § 25A which would be a per student credit equal to 50 percent of qualified expenses paid during the year which do not exceed $3,000. H.R. 4136, 108th Cong. (April 2, 2004). In addition, H.R. 4912, introduced by Rep. Gary L. Ackerman expands the Hope credit to cover 50 percent of all higher education expenses for taxpayers who satisfy the existing income thresholds. H.R. 4912, 108th Cong. (July 22, 2004).

[66] For a similar proposal, *see* Staff of the Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2005 Budget Proposal, JCS-3-04 (U.S. Government Printing Office Feb. 2004), 192-204. The proposal consolidated IRC §221 with the IRC § 25A LLC credit by treating up to $2,500 of student loan interest as a qualified expense.

The maximum allowable amount of the combined credit and its calculation should be based on the tax benefits available to taxpayers through the current provisions. This determination should attempt to minimize the number of "losers" who experience an increase in tax burden as a result of the change, as well as avoiding a disproportionate number of "winners" who benefit.

Consolidating these provisions provides simplification by eliminating the need for the taxpayer to determine exactly which provision(s) to claim in order to receive the most benefit. The current interrelationship between the IRC § 25A credits and the IRC § 222 Deduction for Qualified Tuition and Related Expenses is very confusing, as the credits are calculated differently and the HCS is a per student credit while the LLC is a per return credit. To make matters more complicated, although a taxpayer can claim both credits in one tax year, the two credits cannot be claimed for different expenses related to the same student,[67] nor can the IRC § 222 deduction be taken if the taxpayer claims either IRC § 25A credit for the same student.[68] These proposed amendments also provide modest simplification for taxpayers claiming the IRC § 221 deduction for student loan interest as well as one of the credits under IRC § 25A.

Congress should also consider making the combined credit available in advance and fully refundable.[69] Refundability is the only way to benefit low income taxpayers who cannot receive the benefits afforded under the current deductions, nonrefundable credits and even income exclusions. Nonetheless, refundability introduces additional tax law and administration complexities.

Provide a Uniform Definition of "Student"

For provisions that impose limitations on the relationship between the taxpayer and the student, the definitions of "student" should be uniform. This uniform definition could include the taxpayer, the taxpayer's spouse, the taxpayer's dependents and possibly lineal descendents.[70] Further, the age limitations in IRC § 530 Coverdell ESAs should be eliminated to avoid inadvertent return errors.[71]

[67] IRC § 25A(c)(2)(A).

[68] IRC § 222(c)(2)(A).

[69] An example of legislation on this issue is S. 2087, introduced by Senator Bob Graham, which expands the Hope credit to cover costs up to $2,500 and makes both IRC § 25A credits advanceable and fully refundable. S. 2087, 108th Con (Feb. 12, 2004).

[70] The majority of provisions do not currently include lineal descendants. IRC §§ 25A(f)(1)(A), 135(c)(2)(A), 221(d)(1)(A), 222(d)(1). However, IRC § 408A allows the student to be a grandchild of the taxpayer. IRC §§ 72(t)(2)(E), (7).

[71] American Bar Association Section of Taxation, AICPA Tax Division, and the Tax Executives Institute, Tax Simplification Recommendations, 7 (Feb. 2001).

Congress should also consider the justification for having no relationship requirements for the initial beneficiaries of IRC § 529 plans and IRC § 530 Coverdell ESAs. Unless there is wide and beneficial usage of these provisions for purposes of funding the education costs of beneficiaries outside of the relationship requirement referenced above, such expansiveness may not outweigh the need to simplify the provisions by making the relationship requirements uniform.

Uniform Definitions of "Qualifying Higher Education Expenses" and "Eligible Education Institution"

To reduce the record-keeping burden as well as simplify the provisions, it is necessary to provide as much uniformity as possible to the eligible educational expenses. For purposes of the provisions relating to higher education, uniform references should be made to institutions eligible to participate in Federal student aid programs under Title IV of the Higher Education Act of 1965. To the extent possible, the provisions should include the term "qualifying higher education expenses," which would be defined uniformly to include the following similarly defined items: tuition, fees, books, supplies, equipment, special need services and room and board. The National Taxpayer Advocate understands that the addition of eligible expenses to some provisions and the elimination of some eligible expenses from other provisions would change the scope of the provisions as enacted.[72] However, she believes that the education provisions have become so complex that it is more important to simplify the provisions to reduce the burden imposed on taxpayers.[73]

Uniform Income Thresholds and Uniform Phase-Out Calculations

As discussed above, there is a significant inconsistency in the education provisions with respect to the eligible income levels and the phase-out calculations. Most importantly, the provisions should all refer to the same definition of income, whether MAGI or AGI. Secondly, to the extent fiscally possible, the provisions should be amended to contain uniform income thresholds. Finally, the phase-out formulas should be amended to provide uniform ranges over which the benefits are gradually phased out. Such uniformity would greatly ease the burden on taxpayers who are trying to determine the optimum benefit for their particular situation. This is especially true for those who do not have the

[72] For example, IRC § 135(c)(2) currently defines "qualified higher education expenses" to allow only tuition and fees required for enrollment. The recommended change would increase the amount of eligible expenses.

[73] For examples of proposals on this topic, *see* Department of Treasury, General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals (Feb. 2004), 96-97; Staff of the Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendation of the State of the Joint Committee on Taxation to Simplify the Federal Tax System (April 2001), 126. Section 3(a) of H.R. 4136 amends the definition of "qualified higher education expenses" in IRC §529(e)(3) to exclude nonacademic fees as well as educational expenses related to sports, games or hobbies unless part of the student's degree program. The bill also amends other education provisions (IRC §§ 135, 221 and 222) to include cross-references to the definition included in IRC §529(e)(3).H.R. 4136, 108th Cong. (April 2, 2004).

benefit of a financial or tax advisor.[74]

The exact income threshold amount or phase-out range should be determined based on an analysis of the tax benefits received by taxpayers today and the distribution of the winners and losers of any proposed uniform threshold amount. While the existence of losers (or even a disproportionate amount of winners) is not desirable, the fact that certain individuals may lose tax benefits as a result of the change may be worth the overall benefits of simplification.

Add Inflationary Adjustments

All education provisions should uniformly index for inflation all income thresholds and maximum limits for deductions, credits and contribution. This would also require uniform rounding conventions.

Sunset Provisions

Sunset provisions give Congress a golden opportunity to analyze the effectiveness of newly enacted provisions. During the sunset period, the provisions can be analyzed to determine what is necessary or unnecessary; what needs further simplification; and, in the case of a tax credit, whether the benefit should be refundable. However, once the education incentives in their simplified forms have been analyzed and have passed the testing phase, the provisions should be made permanent to eliminate unnecessary complications for taxpayers planning for future education costs.[75]

Education Campaign

Any changes to the education provisions must be implemented in conjunction with a public education campaign tailored to provide relevant information based on the taxpayers' stage of involvement in education funding and financial literacy levels. The IRS should consider partnering with the Department of Education for this initiative.[76] The following list sets forth various items to include in a comprehensive education and information campaign:

- One campaign can target taxpayers saving for future education costs, providing information on the options available and the tax benefits associated with each one. For example, this effort would provide information on § 135 U.S. savings bonds, § 529 qualified tuition programs, § 530 Coverdell ESAs and § 408A Roth IRAs, as

[74] Statement of Richard Shaw, Chair, Tax Section, American Bar Association, Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means (March 30, 2004), published by Tax Analysts (March 31, 2004).

[75] For the fiscal considerations related to making the tax provisions permanent, *see* William G. Gale and Peter R. Orszag, Brookings Institution, Should the President's Tax Cuts be Made Permanent? (Feb. 24, 2004)

[76] As of December 16, 2004, the official website of the Department of Education directed users to the IRS official website's page on Publication 970.

well as other options available to them that may provide non-income tax type benefits (such as custodial accounts).

- A separate campaign would be aimed at individuals who are currently incurring education expenses or will face them in the near future. This campaign would provide information on the education credits of IRC § 25A and, if still in effect, the above-the-line deductions in IRC § 221 and IRC § 222. As part of this effort, the IRS could provide education institutions with information pamphlets, brochures, Internet material etc.[77] The institutions could distribute such information to students and those individuals responsible for tuition payments.
- A third suggested campaign would target employees and educate them about the various employment related education provisions.
- A fourth campaign could target low income families and families that speak English as a second language (ESL families), and provide information on obtaining help with planning for education costs and claiming available benefits on tax returns.

[77] The IRS currently has useful information titled "Tax Breaks for Education" on its official website at http://www.irs.gov/newsroom/article/0,,id=128874,00.html

TABLE 2.3.1, INCONSISTENCIES AMONG EDUCATION PROVISIONS

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 25A: Hope and Lifetime Learning Credits	Credits gradually phase out after MAGI exceeds $42,000 ($85,000 for married taxpayers filing jointly) in Tax Year 2004.[1] Note that the credits are calculated as follows:HSC= 100% of first $1,000 of qualified expenses and 50% of next $1,000 of qualifying expenses.LLC = 20% of first $10,000 of qualified expenses.[2]	The maximum Hope credit amount of $1,500 is indexed for inflation.[3] The maximum Lifetime Learning Credit Qualified Expenses amount of $10,000 is not indexed for inflation (but it increased from $5,000 to 10,000 in Tax Year 2003).[4] Income thresholds for both credits are adjusted for inflation, subject to a $100 rounding convention[5]	Credit reduction equals credit multiplied by a fraction, the numerator of which is the excess of MAGI over income threshold amount and denominator of which equals $10,000 ($20,000 for married taxpayers filing jointly).[6]	Taxpayer, Taxpayer's Spouse or Taxpayer's Dependent For the Hope Credit, the student must be enrolled in one of the first two years of post-secondary school and must attend at least one semester half-time.[8]	"Qualified tuition and related expenses" includes tuition and fees required for enrollment, with specific exceptions for sports and hobby-related expenses and nonacademic fees.[9]	"Eligible education institution" includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), which includes accredited post-secondary educational institutions offering a bachelor's, associate's, graduate level or professional degree in addition to a proprietary institutions of higher education, postsecondary vocational institutions; and approved foreign institutions of higher education.[10]

[1] IRC § 25A(d); IRS Publication 970, *Tax Benefits for Education for use in preparing 2004 Returns*, Catalog No. 25221V, 14, 22.

[2] IRC §§ 25A(b)(1), (c)(1).

[3] IRC § 25A(b)(4).

[4] IRC § 25A(c)(1).

[5] IRC § 25A(h).

[6] IRC § 25A(d).

[7] IRC § 25A(f)(1)(A).

[8] IRC § 25A(b)(2). Furthermore, the student will not be eligible if convicted of a felony drug charge. IRC § 25A(b)(2)(D).

[9] IRC § 25A(f)(1).

[10] IRC § 25A(f)(2).

TABLE 2.3.1, INCONSISTENCIES AMONG EDUCATION PROVISIONS

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and and Additional Requirements	Type of Expenses	Type of Educational Institution
§117: Exclusion of Qualified Scholarships	No income thresholds	N/A	N/A	Student must be a candidate for a degree.[11]	"Qualified tuition and related expenses" includes tuition and fees required for enrollment and fees, books, supplies and equipment required for courses.[12]	Educational organization described in IRC § 170(b)(1)(A)(ii), which includes primary, secondary and postsecondary schools[13]
§127: Exclusion of Education Assistance	No income thresholds	The maximum exclusion amount of $5,250 is not adjusted for inflation.[14]	N/A	Student must be the Taxpayer and must be an employee.[15]	"Educational assistance" is defined as the payment, by an employer, of expenses for education of the employer including, but not limited to, tuition, fees, and other similar payments, books, supplies and equipment. Does not include payments involving sports, games or hobbies.[16]	Not specified.[17]

[11] IRC § 117(b)(1).

[12] IRC § 117(b)(2).

[13] IRC § 117(a).

[14] IRC § 127(a).

[15] IRC § 127(a)(1).

[16] IRC § 127(C)(1).

[17] IRC § 127(b).

TABLE 2.3.1, INCONSISTENCIES AMONG EDUCATION PROVISIONS

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 135: Exclusion of Income from U.S. Savings Bond	The exclusion of income from U.S. savings bonds is gradually phased out once MAGI exceeds $59,850 ($89,750 for married taxpayers filing jointly) in Tax Year 2004.[18]	Income thresholds are adjusted for inflation, subject to a $50 rounding convention.[19]	The exclusion reduction equals the exclusion multiplied by a fraction, the numerator of which is the excess of the MAGI over the income threshold amount, and the denominator of which is $15,000 ($30,000 for married taxpayers filing jointly).[20]	Taxpayer, Taxpayer's Spouse or Taxpayer's Dependent[21]	"Qualified higher education expenses" include tuition and fees required for enrollment. Such amounts include contributions to IRC § 529 or IRC § 530 accounts. Includes specific exceptions for sports and hobby-related expenses.[22]	"Eligible education institution" includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088).[23]
§ 221: Deduction of Interest on Education Loan	The deduction is gradually phased out after MAGI exceeds $50,000 ($100,000 for married taxpayers filing jointly) for Tax Year 2004.[24]	The maximum deduction amount of $2,500 is not indexed for inflation.[25] The income thresholds are adjusted for inflation, subject to a $5,000 rounding convention.[26]	Deduction reduction equals deduction multiplied by a fraction, the numerator of which is the excess of MAGI over income threshold amount and denominator of which equals $15,000 ($30,000 for married taxpayers filing jointly).[27]	Taxpayer, Taxpayer's Spouse or Taxpayer's Dependent[28]	"Qualified higher education expenses" is defined as the "cost of attendance" as defined by § 472 of the Higher Education Act of 1965 (20 U.S.C 1087).[29]	"Eligible education institution" includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088). The definition also includes institutions conducting an internship or residency program leading to a degree or certificate by an institution of higher education, a hospital or health care facility which offers post-graduate training.[30]

[18] IRC § 135(b)(2)(B).

[19] IRC § 135(b)(2)(C).

[20] IRC § 135(b)(2).

[21] IRC § 135(c)(2)(A).

[22] IRC § 135(c)(2).

[23] IRC § 135(c)(3).

[24] IRC § 221(b)(2)(B)(i)(II).

[25] IRC § 221(b)(1).

[26] IRC § 221(f).

[27] IRC § 221(b)(2)(B).

[28] IRC § 221(d)(1)(A).

[29] IRC § 221(d)(2).

[30] IRC § 221(d)(2).

TABLE 2.3.1, INCONSISTENCIES AMONG EDUCATION PROVISIONS

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 222: Deduction for Qualified Tuition and Related Expenses	In 2004 and 2005, the deduction is limited to $4,000 for taxpayers with AGI not exceeding $65,000 ($130,000 for married taxpayers filing jointly). The deduction is limited to $2,000 for taxpayers with AGI not exceeding $80,000 ($160,000 for married taxpayers filing jointly).[31]	No inflationary adjustments. However, the amount of the deduction has increased from 2002/2003 tax years when the deduction was limited to $3,000 for the lower income tier and zero for the higher income tier.[32]	No phase-out calculation, because deduction amount is limited and differs by income tier.[33]	Taxpayer, Taxpayer's Spouse or Taxpayer's Dependent[34]	"Qualified tuition and related expenses" include tuition and fees required for enrollment; fees, books, supplies and equipment which are a part of a degree program or related to an academic course of instruction.[35]	"Eligible education institution" includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088).[36]
§ 408A: Roth IRA	Generally, the maximum nondeductible contribution of $3,000 is gradually phased out after MAGI exceeds $95,000 ($150,000 for married taxpayers filing jointly).[37]	In general, the maximum contribution amount is scheduled to increase from $3,000 in 2004 to $4,000 in 2005 and $5,000 in 2008 (and indexed for inflation thereafter).[38]	The maximum contribution reduction equals the contribution amount multiplied by a fraction, the numerator of which is the excess of MAGI over income threshold amount and denominator of which equals $15,000 ($30,000 for married taxpayers filing jointly).[39]	Taxpayer, Taxpayer's Spouse, Taxpayer's Dependent or Grandchild.[40]	The 10 percent additional tax on early distributions is not imposed on early distributions used to pay for "qualified higher education expenses," which is defined in the same manner as IRC § 529(e)(3).[41]	"Eligible education institution" includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088).[42]

[31] IRC § 222(b)(2).

[32] IRC §222(b)(2).

[33] IRC § 222(b)(2).

[34] IRC § 222(d)(1).

[35] IRC § 222(d)(1).

[36] IRC § 222(d)(1).

[37] IRC § 408A(c)(3)(C).

[38] IRC §§ 408A(c)(2), 219(b)(5).

[39] IRC § 408A(c)(3)(C)(ii).

[40] IRC §§ 72(t)(2)(E), (7).

[41] IRC §§ 72(t)(2)(E), (7). Note that IRC § 408A does not mention "qualified higher education expenses. IRC § 72(t) provides an exclusion from the 10 percent additional tax imposed on early distribution from any IRA (not just Roth) to the extent used for qualified higher education expenses.

[42] IRC §§ 72(t)(2)(E), (7).

TABLE 2.3.1, INCONSISTENCIES AMONG EDUCATION PROVISIONS

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 529: Qualified Tuition Plans	No income thresholds	N/A	N/A	No relationship requirement. There are beneficiary relationship requirements when changing beneficiary designations.[43]	"Qualified higher education expenses" include tuition, fees, books, supplies and equipment required for enrollment or attendance; special needs services for a special needs beneficiary which are incurred in connection with such enrollment or attendance; and certain room and board expenses.[44]	"Eligible education institution" includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088).[45]

[43] IRC §§ 529(c)(3)(C), (5)(B).

[44] IRC § 529(e)(3).

[45] IRC §§ 529(e)(5).

TABLE 2.3.1, INCONSISTENCIES AMONG EDUCATION PROVISIONS

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 530: Coverdell ESAs	The maximum contribution of $2,000 is gradually phased out after MAGI exceeds $95,000 ($190,000 for married taxpayers filing jointly).[46]	No.	The maximum contribution reduction equals the contribution amount multiplied by a fraction, the numerator of which is the excess of MAGI over income threshold amount and denominator of which equals $15,000 ($30,000 for married taxpayers filing jointly).[47]	No relationship requirement. There are beneficiary relationship requirements when changing beneficiary designations.[48] The student must be younger than age 18 at time of contribution. The account assets must be distributed when the beneficiary reaches the age of 30 unless the beneficiary has special needs.[49]	"Qualified education expenses" includes both "qualified higher education expenses" as defined by § 529(e)(3) and "qualified elementary and secondary education expenses," which include expenses such as tuition, fees, academic tutoring, special needs services for a special needs beneficiary which are incurred in connection with such enrollment or attendance, books, supplies and other equipment, room and board, uniforms and transportation.[50]	Includes "eligible education institutions" described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), primary and secondary schools.[51]

[46] IRC §§ 530(b)(1)(A), 530(c).
[47] IRC § 530(c).
[48] IRC § 530(d)(6).
[49] IRC § 530(b)(1)(A)(ii).
[50] IRC § 530(b)(2)(A).
[51] IRC §§ 530(b)(3),(4)(B).

4 KEY LEGISLATIVE RECOMMENDATION: SIMPLIFICATION OF PROVISIONS TO ENCOURAGE RETIREMENT SAVINGS

PROBLEM

Congress, in an attempt to encourage Americans to save for retirement, has created a system that provides tax incentives for participants of certain retirement accounts. More than a dozen different tax-advantaged[1] retirement planning vehicles are available to the workforce today.[2] While these arrangements have a singular goal of helping taxpayers save for retirement, they are subject to different sets of rules regulating eligibility, contribution limits, tax treatment of contributions and distributions, withdrawals, availability of loans, and portability. This proliferation of options creates complexity and redundancy in the tax law.

Retirement plan administrators (particularly small employers) and participants alike may find themselves at a loss when trying to sort through the unnecessarily complex and often conflicting provisions of the various types of plans. Even more disturbing is the notion that some employers may choose not to offer tax-advantaged retirement plans to their employees due to the enormous complexity of the retirement plan system. Absent compelling policy arguments, it is inefficient and absurd to require taxpayers to learn and apply a new set of rules for each retirement plan.

For example, while some retirement plans allow for an early distribution upon the event of a hardship, the various plans do not uniformly apply these so-called "hardship withdrawal" provisions. 401(k) plans are permitted to allow participants to take an early distribution of their elective deferrals "upon hardship of the employee,"[3] but such distributions are still subject to the 10 percent additional tax on early distributions. 457(b) plans (which cover state and local government employees) are permitted to allow participants to take an early distribution of their entire benefit for an "unforeseeable emergency,"[4] and those distributions, like all 457(b) distributions, are exempt from the 10 percent additional tax. Traditional individual retirement accounts (IRAs) do not allow hardship withdrawals *per se*, but consider first-time home purchases and certain education expenses, among others, to be "qualified distributions," and therefore not subject to the 10 percent additional tax.[5]

[1] The term "tax-advantaged" includes the ability to defer the taxation of income by making an elective deferral, the tax-deferred growth of account assets, and/or the tax-free withdrawals available to plan participants.

[2] We limit our discussion to retirement plans where plan participants make contributions to their account, including, but not limited to, traditional IRAs, nondeductible IRAs, nonworking spousal IRAs, Roth IRAs, rollover IRAs, SIMPLE IRAs, 401(k) and other defined contribution plans for private employers, Simplified Employee Pensions and SIMPLE 401(k) plans for small employers, 403(b) tax-sheltered annuity plans for 501(c)(3) organizations and public schools, and 457(b) deferred compensation plans for state and local governments. We exclude employer-funded defined benefit pension plans from our discussion.

[3] IRC § 401(k)(2)(B)(i)(IV).

[4] IRC § 457(d)(1).

[5] IRC § 72(t)(2).

EXAMPLE

Taxpayer A opened a Roth IRA account three years ago, contributed the maximum each year, and has accumulated a balance of $12,000. Taxpayer A is concurrently employed part-time by Employers B and C. Employer B is a for-profit company that maintains a 401(k) plan for its employees. The present value of Taxpayer A's 401(k) account is $60,000. Taxpayer A also participates in the 457(b) plan maintained by Employer C, a state agency. The present value of Taxpayer A's 457(b) plan, however, is only $18,000, due to poor investment choices.

Taxpayer A is now facing a medical emergency and will require surgery that will cause him to miss six months of work. Because his health insurance will cover only 70 percent of the estimated $50,000 medical expenses, Taxpayer A will need to pay $15,000 out of pocket for his surgery. Moreover, Taxpayer A estimates that he will need an additional $20,000 to cover living expenses for his family during the next six months while he is on unpaid leave.

Taxpayer A recalls that some coworkers from Employer B made "hardship" withdrawals from their retirement plans for occasions such as a home purchase. Taxpayer A would like to know whether he can make an early withdrawal and/or take a plan loan from his IRA or two employer-based plans to help pay for his medical and living expenses for the next six months (during which he will be unable to work). After spending two weeks reading through plan documents and talking with friends, colleagues, and plan administrators, he comes to the following conclusions:

(1) His Roth IRA plan allows for neither plan loans nor hardship withdrawals.

(2) His 401(k) plan with Employer B allows plan loans up to 50 percent of account balance and allows hardship withdrawals of his elective deferrals in instances of "immediate and heavy financial need." Medical expenses, but not living expenses for the period he is unable to work, fall under the safe harbor definition of immediate and heavy financial need. Hardship distributions are included in taxable income, subject to the 10 percent additional tax for early withdrawal.

(3) His 457(b) plan with Employer C allows plan loans up to 50 percent of account balance and allows hardship withdrawals for "unforeseeable emergencies." Severe financial hardship resulting from an illness or accident is considered to be an instance of unforeseeable emergency. The 10 percent additional tax does not apply to a hardship withdrawal from a 457(b) plan.

(4) Retirement plan rules need to be greatly simplified!

RECOMMENDATION

Consolidation of Existing Plans

The National Taxpayer Advocate recommends that Congress consolidate similar plans where the differences in plan attributes are trivial. Consolidation would reduce confusion and may lead to increased participation, or at least to fewer inadvertent errors. For instance, Congress may wish to establish one retirement plan for individual taxpayers, one tailored for small businesses, and one suitable for large businesses (eliminating retirement plans that are limited to governmental entities).[6]

With or without consolidation, making all tax-advantaged retirement plans follow uniform rules regarding early withdrawals, plan loans, and portability is an absolute necessity. Creating a uniform set of rules will (1) eliminate inadvertent errors, (2) enable greater portability among plans, and (3) increase participation by employers.

Uniform Definition of Hardship

The National Taxpayer Advocate recommends that retirement plans adhere to uniform guidelines for allowing an early distribution in situations where a participant is suffering from hardship. The National Taxpayer Advocate further recommends that hardship withdrawals be permitted when a participant is faced with an "unforeseeable emergency." Examples of an unforeseeable emergency may include:

(1) expenses for medical care incurred by the employee, the employee's spouse or dependents;

(2) payments necessary to prevent the eviction of the employee from his or her principal residence or foreclosure on the mortgage on that residence;

(3) loss of property due to casualty; or

(4) severe financial hardship resulting from an extended period of unemployment.

The National Taxpayer Advocate recommends that such hardship distributions be made exempt from the 10 percent additional tax imposed by IRC § 72(t).

Uniform Guidelines for Plan Loans

The National Taxpayer Advocate recommends that retirement plans adopt uniform procedures that allow participants to borrow against plan assets and consider extending these plan loan procedures to all tax-advantaged retirement planning vehicles, including traditional and Roth IRAs. Accordingly, participants should be allowed to borrow against their plan account balance, provided that the loans are:

(1) less than or equal to the lesser of $50,000 or one-half of the participant's account balance;

6 The exact outlines of these plans are beyond the scope of this report, but the rules should be designed to maximize participation and minimize confusion.

(2) repayable within five years (or longer if for the purchase of a primary residence or for education); and

(3) subject to level amortization.

Uniform Guidelines On Portability of Plans

The National Taxpayer Advocate recommends that participants in all tax-advantaged retirement plans be allowed to make rollover distributions to any other tax-advantaged retirement plan. Portability would be extended to simplified employee pensions (SEPs), SIMPLE IRAs, and Roth IRAs, which are excluded from the current rollover distribution provisions.

PRESENT LAW

Congress, in an effort to encourage Americans to save for retirement, has utilized the Internal Revenue Code to confer tax incentives on participants in certain retirement plans. The convenience of automatic periodic contributions to an employer-based retirement plan, combined with the benefit of pre-tax elective deferrals, has made it almost painless for employees to put away funds for retirement. In 2003, 42 percent of all workers participated in an employment-based retirement plan.[7] More telling is that 57 percent of full-time, full-year wage earners between the ages of 21 and 64 (i.e., those most likely to be offered a retirement plan at work) participated in an employment-based retirement plan.[8]

Due to the varying needs of different employers, current law provides for distinct tax-advantaged retirement plans for large businesses, small businesses, governmental entities, and individuals. Private sector employers may allow their employees to make pre-tax contributions to 401(k) defined contribution plans, where an estimated 42 million workers hold plan assets of approximately $1.9 trillion.[9] Small business employers may offer SEP or SIMPLE plans, which are simplified retirement plans with relaxed reporting requirements, to employees (1.1 million such plans in 2002).[10] Public sector employers may allow their employees to participate in a 403(b) tax-sheltered annuity plan or a 457(b) deferred compensation plan, which allow for pre-tax contributions similar to 401(k) plans. In addition, one out of six Americans aged 21 and older own IRAs, with aggregate assets of $2.4 trillion.[11]

Table 2.4.1 summarizes the key provisions of common retirement plans.

7 Employee Benefit Research Institute, *Issue Brief No. 274 – Employment-Based Retirement Plan Participation: Geographic Differences and Trends*, October 2004.

8 *Id.*

9 Employee Benefit Research Institute, *Issue Brief No. 272 – 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2003*, August 2004.

10 Tax Year 2002, Compliance Data Warehouse (CDW), Individual Returns Transaction File (IRTF).

11 Employee Benefit Research Institute, *Notes*, Vol. 23, Number 12, December 2002.

TABLE 2.4.1, RETIREMENT PLAN ELIGIBILITY, CONTRIBUTION & WITHDRAWAL PROVISIONS

	401(k)	403(b)	457(b)	Traditional IRA	Roth IRA	Simple IRA
Who is eligible?	Employees of all non-governmental employers	Employees of 501(c)(3) organizations and public education employers	Employees & independent contractors of state & local governments	Individuals (subject to income limitations if covered by employer-provided retirement plan)	Individuals (subject to income limitations)	Employees of businesses w/ fewer than 100 employees who received > $5,000 compensation in preceding year
Annual contribution limit (2004)	$13,000	$13,000	$13,000	$3,000	$3,000	$9,000
Tax-deferred contribution?	Yes	Yes	Yes	Yes	No	Yes
Tax-free withdrawal?	No	No	No	No	Yes	No
Minimum age for penalty-free distribution	59 ½, unless separated from service	59 ½, unless separated from service	70 ½, unless separated from service	59 ½	59 ½	59 ½
Hardship withdrawal allowed?	Yes, if distribution is necessary to satisfy "immediate and heavy financial need"	Yes, if distribution is necessary to satisfy "immediate and heavy financial need"	Yes, for "unforeseeable emergency"	No	No	No
Loan permissible?	Yes, up to 50% of plan balance ($50K max)	Yes, up to 50% of plan balance ($50K max)	No	No	No	No
Direct rollover allowed?	Yes	Yes	Yes	Yes	Yes, to other Roth accounts	No

Hardship Withdrawals

Some retirement plans allow participants to receive an early distribution in cases of financial hardship such as a medical emergency. However, there is no uniform definition of "hardship" among the various irement plans to enable a participant to easily determine when an early withdrawal is allowable. Further, even if a plan allows for a hardship withdrawal, participants must deal with inconsistent rules for triggering the 10 percent additional tax for early withdrawal imposed by IRC § 72(t). In 2002, approximately 4.5 million tax returns reported tax on early distributions (generating a total tax of nearly $3.1 billion).[12]

401(k) Plans

In general, a 401(k) plan participant may receive a distribution upon the attainment of age $59\frac{1}{2}$ or upon separation of service, death, or disability.[13] However, an early distribution may be made to a 401(k) plan participant "upon hardship of the employee."[14] Applicable Treasury regulations provide that a distribution is made on account of hardship only if (1) the distribution is made due to an immediate and heavy financial need of the employee and (2) the distribution is necessary to satisfy the heavy need.[15]

Whether an employee has an immediate and heavy financial need is to be determined by the plan administrator based on a consideration of all relevant facts and circumstances.[16] However, the regulations provide a safe harbor under which a distribution may be deemed necessary in the following four circumstances:

(1) expenses for medical care incurred by the employee, spouse, or certain dependents;

(2) costs directly related to the purchase of a principal residence for the employee;

(3) payment of tuition, related educational fees, and room and board expenses for the employee, spouse, children, or certain dependents; or

(4) payments necessary to prevent the eviction of the employee from his or her principal residence, or foreclosure on the mortgage of that residence.[17]

A distribution is generally deemed necessary to satisfy an immediate and heavy financial need if:

(1) The distribution does not exceed the amount of the need. This may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

[12] Tax Year 2002, Compliance Data Warehouse (CDW), Individual Returns Transaction File (IRTF).

[13] IRC § 401(k)(2)(B).

[14] IRC § 401(k)(2)(B)(i)(IV).

[15] Treas. Reg. § 1.401(k)-1(d)(2)(i).

[16] Treas. Reg. § 1.401(k)-1(d)(2)(iii).

[17] Treas. Reg. § 1.401(k)-1(d)(2)(iv).

(2) The employee has obtained all other currently available distributions and nontaxable loans under the plan and all other plans maintained by the employer; and

(3) The employer is prohibited from making elective deferrals to the plan and all other plans maintained by the employer for at least six months following the hardship distribution.[18]

The regulations limit hardship distributions to the employee's pre-tax contributions to the 401(k) plan.[19] As such, it appears that qualified matching contributions from the employer are not available for a hardship distribution.

Hardship withdrawals are not eligible for rollover treatment and are includible in the participant's gross income in the taxable year in which paid to the participant and are taxed as ordinary income.[20] In addition, hardship withdrawals are subject to the 10 percent early withdrawal tax imposed under IRC § 72(t) if no exception under IRC § 72(t) applies.

457(b) Plans

In general, a 457(b) plan participant may not receive a distribution until he or she reaches age 70 1/2 or separates from service, whichever is earlier.[21] However, a 457(b) plan may permit an early distribution to a participant faced with an "unforeseeable emergency."[22] The Treasury regulations define unforeseeable emergency as:

(1) a severe financial hardship resulting from an illness or accident;

(2) loss of property due to casualty; or

(3) other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.[23]

This definition is strictly interpreted. The Treasury regulations specifically note that the purchase of a home or the payment of tuition are not unforeseen emergencies for purposes of this exception.[24]

The 10 percent additional tax imposed by IRC §72(t) does not apply to 457(b) plans because a 457(b) plan is not a "qualified retirement plan" as defined in IRC § 4974(c).

[18] Treas. Reg. §1.401(k)-1(d)(2).

[19] Treas. Reg. § 1.401(k)-1(d)(2)(ii).

[20] IRC § 402(a).

[21] IRC § 457(d).

[22] IRC § 457(d)(1)(A)(iii).

[23] Treas. Reg. 1.457-6(c)(2)(i).

[24] Treas. Reg. 1.457-6(c)(2)(i).

IRAs

Distributions from a traditional IRA plan to a participant before the individual has reached age 59 $^{1}/_{2}$ are generally subject to a 10 percent tax in addition to the ordinary income taxes on the distribution.[25] There are several statutory exceptions to the 10 percent additional tax. The 10 percent tax does not apply if the distribution is made in cases of death or disability, certain medical expenses, first-time homebuyer expenses, qualified higher education expenses, heath-insurance expenses of unemployed individuals, or as part of a series of substantially equal periodic payments.[26]

The taxability of a distribution from a Roth IRA generally depends on whether or not the distribution is a "qualified distribution." A qualified distribution for purposes of a Roth IRA is one that is both:

(1) Made after a 5-taxable-year period; and

(2) Made on or after the date on which the owner attains age 59$^{1}/_{2}$, made to a beneficiary or the estate of the owner on or after the date of the owner's death or disability, or to which section 72(t)(2)(F) applies (exception for first-time home purchase).

No provision allows participants in a Roth IRA to receive an early distribution for a hardship (e.g., medical expenses).

Plan Loans

Some retirement plans allow active participants to borrow against benefits. For example, a loan from a 401(k), 403(b), or 457(b) plan will generally not be treated as a taxable distribution if the loan is:

(1) less than or equal to the lesser of $50,000 or one-half of the participant's accrued benefit;

(2) repayable within five years; and

(3) subject to level amortization.[27]

No provision allows IRA holders to borrow against their IRA assets.

Portability

A plan participant is generally given the option to elect a tax-free direct rollover of his or her interest in an eligible retirement plan upon the occurrence of a distributable event under the plan, provided such distribution is transferred to an eligible retirement plan within 60 days of receipt.[28] The Secretary may waive the 60-day requirement where the rollover was delayed due to casualty, disaster, or other events beyond the reasonable control of the individual subject to the requirement.[29]

[25] *See* IRC § 408(d)(1); IRC §72(t).

[26] IRC §§ 72(t)(2).

[27] IRC § 72(p)(2); IRC § 72(p)(4)(A).

[28] IRC § 402(c)(8); IRC § 403(b)(8); IRC § 408(d)(3).

The term "eligible retirement plan," as defined in IRC § 402(c)(8)(B), includes IRAs, 401(k) plans, 403(b) plans, and 457(b) plans. Starting in 2005, rollovers from Roth IRAs may be made, but only to other Roth accounts.[30] Simplified employee pension plans (SEPs) and SIMPLE IRAs are ineligible for rollover distributions to employer-sponsored plans.[31]

REASONS FOR CHANGE

The purpose of this legislative recommendation is to increase participation in retirement plans by simplifying the rules. The current rules were cobbled together over the years as part of a patchwork of legislation, rather than as a byproduct of a well-formulated retirement plan policy. Given that each piece of legislation had a different purpose and objective, it is not surprising to see a framework of increasingly complex rules with sometimes illogical inconsistency.

One study of 401(k) plan participants revealed that 30 percent of non-participants cited confusion about plan features as a reason for not taking part. Between one-third and one-half of these non-participants indicated that they were puzzled by loan rules, vesting rules, hardship withdrawal rules, and the tax-deferred features of the plan.[32] By creating a simplified and uniform set of rules, the National Taxpayer Advocate's proposal would substantially reduce complexity, and eliminate a deterrent to increased plan participation.

Participation in retirement plans may also be promoted by allowing employees the option of borrowing from their accounts. Although less than one quarter of 401(k) plan participants whose plans offer loans take one, participants seem willing to contribute more to a plan if they have the assurance that they may access these funds if necessary.[33] On average, participants in a 401(k) plan offering loans contribute a greater percentage of their salary to the plan than participants in a plan with no loan provision.[34]

With a workforce that has become increasingly mobile, it is imperative that retirement plans allow for portability. Gone are the days where a new employee can expect to work for the same company long enough to receive a gold watch and a pension. Working a lifetime for one employer is now the exception rather than the rule, with today's 32-year-old having worked for an average of nine different companies.[35]

[29] IRC § 402(c)(3)(B).

[30] IRC § 402(c)(8)(B) (flush language).

[31] IRC § 402(c)(8)(B); IRC § 408(d)(3)(G).

[32] Investment Company Institute, *401(k) Plan Participants: Characteristics, Contributions, and Account Activity*, Spring 2000, 11.

[33] Investment Company Institute, *401(k) Plan Participants: Characteristics, Contributions, and Account Activity, spring 2000*, *Id* at figure 5.

[34] Participants in plans allowing loans contribute 0.6 percentage point more of their salary to the plan than participants in a plan with no loan provision. Employee Benefit Research Institute, *Issue Brief No. 238 -- Contribution Behavior of 401(k) Plan Participants*, October 2001; Investment Company Institute, *Perspective*, Vol. 7, No. 4, October 2001, 3.

[35] Department of Labor, *2002 National Summit on Retirement Savings*, Final Report, 4.

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act,[36] which contained a variety of provisions that liberalized employment-based retirement plans. The Act enhanced portability of retirement assets by permitting rollovers from one type of employment-based plan to another, and from IRAs to employment-based plans. However, certain plans designed for employees of small businesses (such as SEPs and SIMPLE IRAs) remain ineligible for rollover to other retirement plans. The National Taxpayer Advocate believes that participants in all retirement plans should have the ability to conduct tax-free rollovers to another retirement plan should they separate from their employer.

EXPLANATION OF RECOMMENDATIONS

The rules covering retirement savings accounts are among the lengthiest and most complicated sections of the tax code and associated regulations.[37] This complexity imposes substantial costs on employers, participants, and the government, and likely has inhibited the adoption of retirement plans by employers, especially small employers.

Many proposals over the years have proposed consolidation and simplification of the retirement plan system.[38] The Joint Committee on Taxation in its 2001 study on tax simplification recommended allowing both public and private sector employers to offer 401(k) plans, stating that consolidation "will reduce complexity by eliminating meaningless distinctions between the types of plans that may be offered by different types of employers. The recommendation will also increase the fairness of the tax laws."[39]

A complete overhaul of the retirement plan system certainly warrants further discussion and study. Whether simplicity can be best be achieved by revamping the entire retirement plan system or by making slight modifications to the current system remains to be seen. It may be years before the Executive branch and Congress come to agreement on the finer points of a simplified plan. In the interim, the National Taxpayer Advocate recommends that Congress consider this proposal as a first step toward simplification.

[36] Pub. L. No. 107-16.

[37] Part of this complexity stems from the fact that retirement plans fall under the jurisdiction of three federal agencies – the IRS, the Department of Labor, and the Pension Benefit Guaranty Corporation.

[38] For example, the Joint Committee on Taxation (JCT) conducted a study in 2001 on simplification of the federal tax system and made many recommendations to remove unnecessary complexity in the retirement plan rules. Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Concerning a Study of the Overall State of the Federal Tax System and Recommendations for Simplification*, JCX-26-01, April 26, 2001. President George W. Bush has made retirement plan simplification proposals in each of the past two years. Under the latest proposal, IRAs would be replaced by two new savings accounts: Lifetime Savings Accounts and Retirement Savings Accounts. The Administration also proposes to consolidate 401(k), 403(b), and 457(b) plans, as well as SEPs and SIMPLE IRAs, into a single type of plan – Employee Retirement Savings Accounts – that would be available to all employers. Treasury Department, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals* (February 2004); Treasury Department, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals* (February 2003).

[39] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System*, JCS-3-01, April 2001.

5 KEY LEGISLATIVE RECOMMENDATION: OFFER IN COMPROMISE: EFFECTIVE TAX ADMINISTRATION

EQUITABLE CONSIDERATIONS

PROBLEM

Prior to 1998, the Internal Revenue Service (IRS) would consider offers to compromise tax liabilities for less than the full amount based upon "doubt as to liability" or "doubt as to collectibility."[1] In 1998, Congress clarified that the bases on which the IRS could accept an offer in compromise (OIC) also included "effective tax administration" (ETA).[2] The conference report to the 1998 legislation stated that the IRS was to "take into account factors such as equity, hardship, and public policy."[3]

The IRS' administrative guidance indicates that compromises based on equity and public policy will be made only in rare and exceptional circumstances.[4] Consistent with this guidance, anecdotal evidence suggests that the IRS has rarely used its authority to compromise based on such considerations.[5] In fiscal year 2004, the IRS' ETA Offer Group, which is responsible for processing offers based upon equity and public policy, accepted a single offer. One reason for this is that the IRS "assumes that Congress imposes tax liabilities only where it determines it is fair to do so."[6] However, a logical extension of this principle would eliminate equity and public policy as a basis for compromise (rather than just making acceptance on this basis "rare"), since every tax liability is imposed by law.[7]

Tax laws, however, are not always "fair" when applied to a given set of circumstances. Equitable and fair tax laws are simple and predictable. They do not subject taxpayers to unreasonable surprise or require payment at a time when the taxpayer has not received a

1 *See, e.g.*, Form 656, Offer in Compromise (Rev. 1-1997).

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

3 *Id.*

4 *See* T.D. 9007, 67 Fed. Reg. 48,025, 48,026 (July 23,2002) (preamble); IRM 5.8.11.2.2(1) (Rev. 5-15-2004); IRM 5.8.11.4.1(1) (5-15-2004).

5 However, IRS does not track receipts or dispositions of ETA offers. Response to TAS Information Request (June 2, 2004).

6 *See, e.g.*, IRM 5.8.11.2.2(1) (Rev. 5-15-2004). *See also*, IRM 5.8.11.2.2(3) (Rev. 5-15-2004) (stating: "Compromise on public policy or equity grounds is not authorized based solely on a taxpayer's belief that a provision of the tax law is itself unfair. Where a taxpayer is clearly liable for taxes, penalties, or interest due to operation of law, a finding that the law is unfair would undermine the will of Congress in imposing liability under those circumstances.") The preamble to the final regulations notes that "the IRS will presume that the correct application of the tax laws produces a fair and equitable result, absent exceptional circumstances." T.D. 9007, 67 Fed. Reg. 48,025, 48,027 (July 23, 2002) (preamble). Few exceptional circumstances are identified, potentially leading some to conclude that facts and circumstances must match those of an example in the regulations in order to qualify.

7 Such a logical extension of this principle is obviously faulty given the existence of examples in the regulations illustrating situations in which compromise on the basis of equity and public policy is appropriate. *See* Treas. Reg. § 301.7122-1(c)(3)(iv).

net amount sufficient to satisfy the liability.[8] They do not impose an income tax on a transaction in excess of the economic benefit received from it. They do not penalize taxpayers for the IRS' administrative action or inaction, such as through the accrual of interest and penalties (in excess of the time value of money) during periods of unreasonable delay by the IRS in determining a taxpayer's liability.[9] The absence of a remedy for such inequities may lead the public to either disregard the law or lose faith in the fairness of the income tax system.[10]

EXAMPLES

Example 1: Incentive Stock Options and the Alternative Minimum Tax[11]

A customer service supervisor at a technology company was granted incentive stock options (ISOs) as part of his compensation package. He exercised them in early 2001, when the fair market value of the stock was much higher than the exercise price of the options. The benefit of an ISO, as compared to other options, is that (1) ISOs are not subject to regular income tax (or income tax withholding) upon exercise and (2) if the stock received upon exercise of the option is held for the requisite period, any gains are ultimately taxed at favorable long term capital gains rates.[12] The taxpayer did not anticipate that exercising his options to purchase stock could subject him to Alternative Minimum Tax (AMT) liability disproportionate to his economic benefit from the transaction. Because the difference between the stock purchase price and the value of the stock (when purchased) is added back to income in determining AMT, the stock purchase created AMT liability of over $265,000 (as compared to his regular tax liability for the year of less than $1,600) even though the taxpayer had not yet sold the stock and had not been subject to withholding.[13] The following year, before the AMT liability was required to be paid, the stock value dropped sharply to less than the AMT liability. The result was that the tax liability exceeded the taxpayer's economic benefit from the transaction. The taxpayer filed an OIC with the IRS seeking relief from the AMT liability based upon ETA. The IRS rejected the offer.

[8] The Treasury Department has suggested that these principles are one reason to consider a consumption tax in lieu of the current tax system. *See* Department of the Treasury, *Blueprints For Basic Tax Reform*, 42-43 (January 17, 1977) (available at www.treas.gov/offices/tax-policy/library/blueprints).

[9] H.R. Conf. Rep. No. 599, 105th Cong., 2nd Sess., 289 (1998).

[10] This may have been part of the reasoning behind the statement in the 1998 legislative history linking ETA to voluntary compliance. H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998) (stating that "[t]he conferees believe that the ability to compromise tax liability … enhances taxpayer compliance.").

[11] The National Taxpayer Advocate has previously recommended fixing the AMT. *See, e.g.*, National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 5.

[12] *See* Ginsburg and Levin, *Mergers, Acquisitions, and Buyouts*, ¶1502.2.1 (June 30, 2003).

[13] Although the taxpayer's tax liability was triggered at the same time that it would have been triggered if his option were not an ISO, in that case his employer would have had an income tax withholding obligation. This would have allowed the taxpayer to avoid the most inequitable consequences of the tax rules because employer withholding would have prepaid much of his tax and put him on notice (before the stock value declined) that a tax liability resulted from the option exercise.

Example 2: Attorney Fee Awards in Nonphysical Injury Cases[14]

A taxpayer who was subject to age discrimination filed a lawsuit, with his attorney agreeing to accept a portion of any recovery as his fee. When the suit was settled in the early 1990s, the taxpayer agreed to a lesser amount based upon his reasonable understanding that he would not be taxed on the amount paid to his attorney. A court recently decided that the portion of the settlement that went to pay the taxpayer's attorney was taxable to him. Thus, the taxpayer's total tax liability on the settlement exceeded the net settlement amount after reduction for costs and attorney fees. The taxpayer submitted an OIC based on equity/public policy ETA considerations, which the IRS did not accept.

Example 3: Unreasonable IRS Delay

In the late 1990s, a taxpayer entered into a closing agreement with the IRS to settle a tax shelter investment with respect to tax years in the early 1980s. The agreement that the IRS drafted required reversals of tax shelter items. The IRS made the reversals that increased the taxpayer's liability but not the reversals that would have reduced it. During the years following the execution of the closing agreement, the taxpayer repeatedly contacted the IRS about the reversals. The taxpayer did not pay liabilities associated with the years at issue, in part because the IRS had not made the reversals, which he believed would offset much, if not all, of the liability and interest for those years. In 2004, the IRS made all of the outstanding reversals. However, during the years that the taxpayer's net liability was unsettled, a punitively high rate of interest accrued on the liability because it related to a tax shelter investment. The taxpayer submitted an OIC based upon ETA. The IRS would not accept an offer amount reduced by interest that accrued during the full period of unreasonable IRS delay in making the reversals.

RECOMMENDATION

The National Taxpayer Advocate recommends that the IRS be given more specific direction to compromise tax liabilities in cases where it is inequitable to collect them, notwithstanding the fact that such amounts are legally due pursuant to a technical application of the Code and not subject to abatement under other rules. Specific recommendations follow:

Add new paragraph 7122(c)(4) of the Code to read as follows:

> "SPECIAL RULES RELATING TO OFFERS BASED UPON EQUITABLE CONSIDERATIONS. – Notwithstanding any other provision of this title, the

[14] The National Taxpayer Advocate has previously recommended eliminating this trap. *See* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), 160 (legislative recommendation regarding attorney fees). Section 703 of the American Jobs Creation Act of 2004 (P.L. 108-357) allows plaintiffs a deduction for attorneys' fees and costs (not subject to the two-percent floor or AMT) in certain employment and discrimination cases, applicable to certain amounts paid after the date of the enactment. IRC § 62(a)(19).

Secretary shall compromise a liability when it is inequitable to collect any unpaid tax (or any portion thereof, including penalties and interest).

(A) It shall be deemed inequitable to collect an income tax liability in excess of the economic benefit received from the transaction to which the liability relates. For purposes of this section, a transaction shall include all related transactions.

(B) In other cases, the Secretary shall consider all of the facts and circumstances, including:

i. whether the taxpayer acted reasonably and in good faith under the circumstances, such as, by taking reasonable actions to avoid or mitigate the situation;

ii. whether an income tax liability is disproportionate to (even if not in excess of) the economic benefit received from the transaction to which the liability relates;

iii. whether the taxpayer is a victim of a third-party bad act or other unexpected event;

iv. whether the taxpayer has a recent history of compliance with tax filing and payment obligations or a reasonable explanation for noncompliance;

v. whether any IRS employee has not followed standard procedures in connection with the case, including applicable published administrative guidance (such as the Internal Revenue Manual);

vi. whether IRS action or inaction has unreasonably delayed resolution of the taxpayer's case; and

vii. any other relevant fact or circumstance indicating that justice, equity or public policy justifies the compromise.

No single fact or circumstance described in clause (i)-(vii), above, shall be determinative of whether to compromise a liability under subparagraph (B). This determination shall be made without regard to the taxpayer's ability to fully pay the liability. Compromises under this paragraph 7122(c)(4) may require appropriate adjustments to basis, carryovers, or other tax attributes.

Equitable consideration offers (ECOs) would replace equity/policy ETA offers as a basis for compromise.

PRESENT LAW

Historic Background

The debate over the extent to which the IRS should compromise a liability based upon equitable considerations has been ongoing for at least the last century. In 1863, a predecessor of the statute providing the IRS' current authority to compromise was enacted, in part, so that each case was not brought before Congress.[15] Neither the original statute nor the current compromise statute place explicit limits on this authority.[16] In 1933, however, Attorney General Cummings issued an opinion that the IRS had no power to compromise tax liabilities based solely upon equitable considerations.[17] While this opinion was consistent with a few prior opinions, the IRS' willingness to compromise based upon equitable considerations had previously been somewhat unsettled.[18]

Recent Developments

In 1998, Congress clarified that offers could be accepted based upon "effective tax administration" (ETA).[19] Factors such as equity, hardship, and public policy were to be considered.[20] Under Treasury regulations, these three bases for compromise were collapsed into two: "economic hardship" and "equity/public policy."[21]

Treasury regulations explain that "equity/public policy" offers (sometimes called "non-hardship" ETA offers) may be accepted in exceptional circumstances, regardless of the taxpayer's financial circumstances, if (a) there are no other grounds to compromise, (b) collection of the liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner, (c) the taxpayer can demonstrate circumstances that justify compromise even though a similarly situated taxpayer may have paid his liability, and (d) the proposed compromise would not undermine tax compliance.[22]

[15] Cong., Globe, 37th Cong., 3rd Sess. (1863), *reprinted in* J.S. Siedman, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861 (Prentice Hall) at 1060 (statements of Representative Fessenden).

[16] Act of Mar. 3, 1863 § 10 (H.R. 506, 37th Cong., 3rd Sess., ch. 76, 12 Stat. 737, 740) *reprinted in* J.S. Siedman, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861 (Prentice Hall) at 1060; IRC § 7122.

[17] See Op. Atty. Gen 6, XIII-47-7138 (Oct. 24, 1933), *excerpts reprinted in* TD 8829, 64 Fed. Reg. 39,020, 39,021 (July 21, 1999).

[18] *Compare* T.D. 8829, 64 Fed. Reg. 39,020, 39,021 (July 21, 1999) (preamble) (noting consistency with prior opinions), with 36 Op. Atty. Gen. 40 (May 8, 1929) (quoting and distinguishing 17 Op. 213, in which Attorney General MacVeagh expressed the opinion that "while, in considering any compromise submitted to your judgment, you are not at liberty to act from motives merely of compassion or charity, you are at liberty, until Congress sees fit to limit your authority, to consider not only the pecuniary interests of the Treasury, but also general considerations of justice and equity and public policy."). Subsequent analyses have questioned the reasoning of the Cummings opinion. *See* GCM 24147 (August 13, 1942).

[19] H.R. Conf. Rep. No. 599, 105th Cong., 2nd Sess., 289 (1998).

[20] *Id.* Because the Code places no express limits on IRS' ability to compromise, this clarification was accomplished via legislative history, without expressly expanding IRS' authority to compromise. *Id.*

[21] Treas. Reg. § 301.7122-1(b)(3).

[22] Treas. Reg. § 301.7122-1(b)(3). A general requirement for the acceptance of any ETA offer is that compromise must not undermine compliance which generally means that the taxpayer must have a history of tax filing and payment compliance and must not have either taken deliberate actions to avoid the payment of taxes or encouraged others to refuse to comply with the tax laws. Treas. Reg. § 301.7122-1(b)(iii); Treas. Reg. § 301.7122-1(c)(iii); IRM 5.8.11.2.1(7) (Rev. 5-15-04). In addition, equity/policy ETA offers are only considered if there is no basis to compromise based upon "doubt as to liability" and "doubt as to collectibility." Treas. Reg. § 301.7122-1(b)(ii); IRM 5.8.11.1(3) (Rev. 5-15-2004); IRM 5.8.22.2(1) (Rev. 1-1-2000). However, ETA considerations are also taken into account in offers based upon doubt as to collectibility with special circumstances. IRM 5.8.11.2(2) (Rev. 5-15-2004).

The IRS will not compromise solely on the basis that the law is unfair.[23] The IRS will not compromise solely on the basis of delay by the IRS, particularly delay that does not support relief under the interest abatement rules.[24] The IRS has also extended this rationale to penalties.[25] Similarly, the IRS will not compromise solely on the basis of the misdeeds of third parties.[26]

REASON FOR CHANGE

The conference report to the 1998 legislation stated that --

> … [offer-in-compromise] regulations will be expanded so as to permit the IRS, in certain circumstances, to consider additional factors (i.e., factors other than doubt as to liability or collectibility) in determining whether to compromise the income tax liabilities of individual taxpayers. For example, the conferees anticipate that the IRS will take into account factors such as equity, hardship, and public policy where a compromise of an individual taxpayer's income tax liability would promote effective tax administration. The conferees anticipate that, among other situations, the IRS may utilize this new authority to resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability… the conferees believe that the IRS should make it easier for taxpayers to enter into offer-in-compromise agreements…[27]

As discussed above, the IRS has not fully embraced this statement, perhaps because of concurrence by some with Attorney General Cumming's 1933 opinion that compromises based upon justice, equity, or public policy should be made only "at the insistence of Congress."[28] The National Taxpayer Advocate believes that Congress needs to "insist" by providing more specific guidance regarding how equitable considerations will be taken into account. Although the National Taxpayer Advocate believes that the IRS has the authority to adopt the proposals provided herein, it has not done so.[29]

---

[23] IRM 5.8.11.2.2(3) (Rev. 5-15-2004).

[24] T.D. 9007, 67 Fed. Reg. 48,025, 48,027 (July 23, 2002) (preamble); IRM 5.8.11.2.2(4) (Rev. 5-15-2004) (same). *Accord* IRM 4.18.3.4(3) (Rev. 1-1-2000).

[25] *See* IRM 5.8.11.2.2.(9) (Rev. 5-15-2004); IRM 5.8.11.2.2(3) (Rev. 5-15-2004).

[26] T.D. 9007, 67 Fed. Reg. 48,025, 48,027 (July 23, 2002) (preamble); IRM 5.8.11.2.2(10) (Rev. 5-15-2004).

[27] H.R. Conf. Rep. No. 599, 105th Cong., 2nd Sess., 289 (1998).

[28] Op. Atty. Gen 6, XIII-47-7138 (Oct. 24, 1933), *excerpts reprinted in* TD 8829, 64 Fed. Reg. 39,020, 39,021 (July 21, 1999). As noted above, however, subsequent analyses had questioned the reasoning of the Cummings opinion.

[29] We understand that IRS is currently considering a proposed change in policy that would allow it to compromise based on some of the factors identified above. However, IRS' proposal would not allow the IRS to compromise on the basis that tax liability is disproportionate to (or exceeds) the economic benefit received by the taxpayer from the transaction.

Tax Traps

A technical application of complex tax laws sometimes produces inequitable results. Such results may favor the government (called "traps for the unwary" or "tax traps") or the taxpayer (called "tax shelters") in any given instance.[30] IRS guidance that a compromise based upon equity/public policy may not be made based upon the unfairness of the tax rules is inconsistent with the reality that even generally fair tax rules may, in certain circumstances, produce unfair results. Oral arguments before the Supreme Court regarding the attorney fee "tax trap," similar to *Example 2* (above), recently included the following exchange:[31]

> JUSTICE BREYER: …a Congress that seems to be willing to take away deductions for expenses that lead to the income, could produce an income tax that in many cases, not just a few, exceeds the income that an individual has. And I would like to know what in the law is there to guard against that result….
>
> JUSTICE KENNEDY: Other -- other than the mercy of the Internal Revenue Service. (Laughter.)
>
> ***
>
> JUSTICE KENNEDY: This is not income in any – in any real sense.
>
> JUSTICE BREYER: Is there any constitutional protection? The Sixteenth Amendment refers to an income tax, and perhaps that doesn't include a tax that grossly exceeds in many cases a person's income. That would be quite a far-out theory at the moment.
>
> JUSTICE BREYER: But I -- that's why I ask you. Is there any protection in the law whatsoever? Or if Congress decides to tax a set of people who, let's see - say, earn $10,000 a year and because they're small business people, they happen to have $20,000 expenses. So it taxes them on $20,000, and the tax exceeds the income. There's no protection in your view against that result. And you just said, well, Congress decided to do it, it decided to do it.
>
> ***
>
> JUSTICE BREYER: What about an assumption, for example, that when we read the code, we read it with a view towards thinking Congress did not want to produce such **unfair** results? (Emphasis added).

[30] According to Department of Treasury, "[c]orporate tax shelters typically rely on some type of discontinuity in the tax law that treats certain types or amounts of economic activity more favorably than comparable types or amounts of activity…. Discontinuities exist in the tax law for several reasons. Most importantly, the Code does not measure economic income precisely. Rather, the Code incorporates a number of simplifying conventions to address various concerns, such as liquidity, complexity (including valuation concerns), and administrability. These simplifying conventions, however, provide opportunities for manipulation and are a major source of tax shelter activity." Department of Treasury, White Paper, *The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals* (July 1, 1999) (available at http://www.treas.gov/press/releases/reports/ctswhite.pdf) at 10.

[31] Oral arguments before the Supreme Court for the consolidated appeal of *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003) and *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003), conducted November 1, 2004 at 5-26 (available at http://www.supremecourtus.gov/oral_arguments/argument_transcripts/03-892.pdf).

The Court's discussion reflects the common sense notion that net income (rather than gross income) is the only proper measure of a taxpayer's income.[32] When a tax liability is disproportionate to the economic benefit derived from a transaction, the tax is likely to upset reasonable expectations and notions of fairness.[33] This is not unlike the unfairness that results when a tax shelter transaction results in tax benefits that exceed the true economic costs of the transaction.[34]

Although some taxpayers may be able to avoid tax traps by obtaining timely advice of qualified counsel, others will not be as well prepared. This may further the perception that the tax rules are not fair and place disproportionate burdens on taxpayers least able to handle them. Such a perception would be consistent with pre-existing notions that "only little people pay taxes,"[35] which are based on the idea that rich and well-advised taxpayers can minimize their taxes by engaging in legal tax shelter transactions. Thus, tax traps may have the potential to erode voluntary compliance in much the same way as the perception of unfairness created by the existence of tax shelters.[36]

The tax shelter problem, however, has been addressed more aggressively than the tax trap problem. The IRS has authority, procedures and motivation to fix many tax shelters administratively.[37] For example, taxpayers are required to report transactions that meet

[32] *See, e.g.*, MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION, A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS, 95 (8th ed. 1997) (noting that "[o]ur income tax system is premised on the idea that enrichment is the best measure of a taxpayer's ability to bear the costs of government. While gross income may give some indication of the taxpayer's income status, it would obviously be arbitrary and in many instances highly unfair to accept that figure as final.") (Emphasis added).

[33] Taxing a person on income from which they received no significant benefit is also a factor in considering whether equitable relief should be available under the innocent spouse rules. *See, e.g.*, Treas. Reg. § 1.6015-2(d); Rev. Proc. 2003-61, 2003-32 I.R.B. 296; H.R. Rept. No. 432, 98th Cong., 2d Sess., pt. 2, at 1502 (1984).

[34] In contrast to the IRS' approach to tax traps, the IRS has been willing to settle various partnership tax shelters by eliminating both phantom income and phantom deductions. IRM 35.24.3.1(1)(g)(2)(b) (Rev. 3-9-1994); IRM Exhibit 35.24.3-8 (Rev. 3-9-1994) (Sample letter for Rule 248(b) Cash Out-of-pocket Settlements).

[35] Jeffery L. Yablon, *Certain As Death – Quotations About Taxes (2004 EDITION)*, 102 TAX NOTES 99 (Jan. 5, 2004) (attributed to Leona Helmsley).

[36] *See, e.g.*, Kim M. Bloomquist, *Income Inequality and Tax Evasion: A Synthesis*, SECOND EDITION OF THE OECD JAN FRANCKE TAX RESEARCH AWARD (March 20, 2003), available at http://www.oecd.org/dataoecd/51/26/2501390.pdf (citing studies suggesting that growing dissatisfaction with the tax system, perception of unfair treatment, and perception with the value received is less than taxes paid may be causes of noncompliance).

[37] *See, e.g.*, IRC § 269 (permitting IRS to disallow any deduction, credit or other allowance where control of a corporation is acquired and "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of such deduction, credit, or other allowance"), § 482 (permitting IRS to distribute, apportion, or allocate gross income, deductions, credits, or allowances between taxpayers owned or controlled directly or indirectly by the same interests, if necessary to prevent evasion of taxes or to clearly to reflect income), § 446(b) (permitting the Secretary to put a taxpayer on a method of accounting that "clearly reflects income"). *See also*, Treas. Reg. § 1.701-2 (partnership anti-abuse rules); Treas. Reg. § 1.1502-13(h)(1) (consolidated return anti-abuse rules); Treas. Reg. § 1.1502-17(c) (providing anti-abuse rule concerning methods of accounting); Treas. Reg. § 1.1502-19(e) (providing anti-abuse rule concerning excess loss accounts). Various judicial doctrines (*e.g.*, "economic substance" or "substance over form") effectively give the IRS additional authority to eliminate many other tax shelters administratively or through litigation.

certain criteria to the IRS Office of Tax Shelter Analysis, which coordinates IRS enforcement efforts.[38] In addition, a Senior Counsel and a staff of attorneys lead an IRS task force initiative to expedite published guidance.[39]

In contrast, no comprehensive procedures exist to identify and fix tax traps quickly before significant loss to taxpayers can occur. Thus, some traps will remain undetected or at least unfixed for extended periods, especially those that affect only a small number of taxpayers.

In some cases, changing the law to eliminate tax traps would have broad ramifications in areas outside of a given case, potentially creating complexity, tax shelters or other tax traps. Congress' or IRS' inability to provide proactive relief to all taxpayers (via legislative or administrative guidance) should not prevent taxpayers that submit an OIC from obtaining relief. In fact, one reason that the IRS was given the power to compromise tax liabilities was to eliminate the need for taxpayers to ask Congress for relief.[40] Instead, the IRS was to provide relief on a case by case basis, as appropriate.

The IRS is concerned that using the OIC process to alleviate inequitable situations is itself inequitable because other similarly situated taxpayers may have paid the liability and not submitted an OIC.[41] However, the inequity presented when a taxpayer who would be eligible for an OIC does not submit one is no worse than the inequity presented when the taxpayer fails to take a deduction to which he or she would have been entitled. Further, under the IRS' reasoning tax shelter investors could argue (incorrectly) that it is unfair when they are made to pay because other similarly situated investors are not always made to pay. Sometimes, as a practical matter, equitable relief can be provided only on a case-by-case basis.[42]

IRS Responsibility for Liability

In some cases a liability for tax, interest or penalties may accrue by reason of unreasonable IRS action or inaction, such as unreasonable delay. In such cases where IRS bears some responsibility for the liability, collection of the liability in full may nonetheless be inequitable because taxpayers should not be penalized for IRS errors. An example in the final Treasury regulations of when an equity/public policy ETA compromise is appropri-

[38] Treas. Reg. § 1.6011-4(e)(1).

[39] Announcement 2000-12 I.R.B. 835; IR-2003-16, 2003 TNT 30-7.

[40] Cong., Globe, 37th Cong., 3rd Sess. (1863), *reprinted in* J.S. Siedman, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861 (Prentice Hall) at 1060 (statements of Representative Fessenden).

[41] Treas. Reg. § 301.7122-1(b)(3)(ii) IRM 5.8.11.2.2(10) (Rev. 5-15-2004).

[42] As the Supreme Court has said "taxes are the lifeblood of government, and their prompt and certain availability an imperious need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection…[therefore] the statutes, in a spirit of fairness, invariably afford the taxpayer an opportunity at some stage to have mistakes rectified." *Bull v. US*, 295 U.S. 247, 259-260 (1935). Applying this reasoning to tax traps, the operation of the tax trap is itself a "mistake" and the OIC process presents a way to have the mistake rectified before collection occurs.

ate illustrates this principle.[43] In the example, the IRS provides inaccurate written advice to a taxpayer regarding how to roll over his IRA while preserving its tax benefits and avoiding penalties. The taxpayer relies on this advice and incurs liability for tax, penalties, and additions to tax. The example concludes that compromise is appropriate.

However, implicit limitations on the general principle (illustrated by the example in the regulations) that taxpayers should not be penalized based upon unreasonable IRS action or inaction would deny relief in most such cases. The example states that had it not been for the erroneous written advice, the taxpayer would have avoided the penalty. Thus, even in cases where the IRS concludes that it was at fault, the IRS is likely to distinguish the facts of the example from the taxpayer's case unless he or she has received erroneous written advice from IRS and can prove what would have transpired in the absence of such advice. In fact, IRS guidance indicates that IRS will not compromise based solely upon delay or other IRS actions that do not support relief under penalty or interest abatement provisions.[44]

The form of the IRS' erroneous advice, evidence regarding what might or might not have occurred in the absence of such advice, and the ability or inability of IRS to abate a liability for interest or penalties under the Code's abatement provisions should not be determinative of whether interest or penalties should be compromised in connection with an OIC. Rather, equitable considerations should be the focus of the inquiry. Like substantive tax rules, the Code's interest and penalty relief provisions may not always operate equitably or even as intended. Moreover, legislators must have determined that those relief provisions would not always produce an equitable result when the conferees explained that the IRS may "utilize this [ETA] authority, to resolve longstanding cases by forgoing penalties and interest which have accumulated as a result of delay in determining the taxpayer's liability."[45]

Although the IRS' policy of not compromising "solely" based upon delay or other actions that do not support relief under penalty or interest abatement provisions theoretically leaves room for compromise if other factors are present,[46] no other facts or circumstances have been identified, except the example from the Treasury regulations (described above), that would lead to a conclusion that relief is appropriate.

Unexpected Events and Third Party Acts

Unexpected events (including third party bad acts) that result in an unpaid tax liability are relevant to the determination of whether a compromise is equitable. Such events put the

[43] Treas. Reg. § 301.7122-1(c)(3)(iv)(Ex. 2).

[44] IRM 5.8.11.2.2(3) (Rev. 5-15-2004). IRM 5.8.11.2.2(4) (Rev. 5-15-2004); IRM 4.18.3.4(3) (Rev. 1-1-2000). *See also* T.D. 9007, 67 Fed. Reg. 48,025, 48,027 (July 23, 2002). However, IRS Commissioner Everson has publicly stated that the IRS does not believe the compromise of interest not subject to abatement is precluded. Mark Everson, *IRS Responds to Taxwriters' Offer in Compromise Concerns*, 2004 TNT 231-25, 6 (Dec. 1, 2004).

[45] H.R. Conf. Rep. No. 599, 105th Cong., 2nd Sess. 289 (1998).

[46] IRM 5.8.11.2.2(3) (Rev. 5-15-2004). IRM 5.8.11.2.2(4) (Rev. 5-15-2004); IRM 4.18.3.4(3) (Rev. 1-1-2000).

taxpayer's actions in context and help explain the taxpayer's failure to recognize a tax trap as well as the reasonableness of the taxpayer's actions under the circumstances. An example in the Treasury regulations illustrates this point.[47] A taxpayer does not file or pay his taxes because he is incapacitated by illness, and the example concludes that compromise is appropriate because the illness prevented the taxpayer from fulfilling his obligations. The IRS' decision to compromise should not change simply because the taxpayer's incapacitation was caused by a third party rather than by an illness. The focus should instead be on whether the taxpayer acted reasonably under the circumstances and whether compromise would be equitable.[48]

As with interest and penalty cases, the IRS' policy of not compromising "solely" based upon third party acts theoretically leaves room for compromise when a taxpayer has suffered at the hands of third parties if other factors are present, but no other facts or circumstances have been identified that would lead to a conclusion that relief is appropriate in such instances.[49]

EXPLANATION OF RECOMMENDATION

In cases involving "tax traps," which result in tax liability in excess of the economic benefit from a transaction, the law is operating inequitably regardless of the reasonableness of a taxpayer's actions.[50] In such cases, factual inquiries are avoided by simply requiring the IRS to compromise to the extent the liability exceeds the economic benefit (further reduction of the liability, however, would require additional factual inquiry).[51] This may result, for example, from a technical application of the annual accounting rules (gains and losses in different years), deduction limitation rules, realization rules (phantom income realized and real income not obtained), or the character rules (gains not offset by losses).[52] Regulations would

[47] Treas. Reg. § 301.7122-1(c)(3)(iv)(Ex. 1).

[48] IRS is concerned that compromise on the basis of unexpected events such as third-party acts would make the government a *de facto* insurer of poor business decisions or financial misdeeds suffered at the hands of third parties. *See* T.D. 9007, 67 Fed. Reg. 48,025, 48,027 (July 23, 2002) (preamble). However, the only difference between *de facto* "insurance" against illness, illustrated by the example provided in the final ETA regulations, and "insurance" against embezzlement by third parties seems to be the level of difficulty in determining whether the taxpayer acted reasonably in protecting himself from the illness or theft, respectively. In addition, because compromises on the basis of third party acts would typically involve the compromise of liabilities resulting from such acts, such compromises would merely reduce the adverse tax consequences suffered by the victim. Just as the theft loss deduction does not make taxpayers abandon all precautions against theft, compromise in such cases this would not make taxpayers abandon precautions against third party bad acts, especially since the reasonableness of the taxpayer's actions would be at issue in connection with an ECO.

[49] IRM 5.8.11.2.2(10) (Rev. 5-15-2004) (stating "[t]he Service will not compromise on public policy or equity grounds based solely on the argument that the acts of a third party caused the unpaid tax liability.").

[50] Refining the definition of an "economic benefit" could involve some of the same challenges as the defining net income. However, the IRS has been able to define "significant benefit" in the context of innocent spouse claims, which is a very similar concept.

[51] Of course this analysis should also take into account time value of money concepts.

[52] Although this may result in a relatively greater number of OIC submissions during economic downturns when tax liabilities resulting from a transaction may be more likely to exceed the economic benefits from it, such trends may be helpful in alerting policymakers to the existence of tax traps so that they can be addressed through legal or administrative guidance. Any resulting administrative burden that this places on the IRS could be minimized through the adoption of standard settlements initiatives, such as those used for resolving tax shelter cases.

clarify the scope of what constitutes a "transaction" and a "related transaction" for purposes of these rules, with the expectation that the definition would be broadly drawn to take into account true economic benefits realized by the taxpayer at the time he or she was required to pay the liability. The IRS would require correlative adjustments to tax attributes in connection with accepted ECOs to ensure that the taxpayer is not relieved of tax liability while retaining corresponding tax benefits, such as basis increases or loss carryforwards resulting from the transaction giving rise to the compromised liability.

In other cases, a central inquiry would be whether a taxpayer facing an unexpected liability acted reasonably and in good faith under the circumstances. The taxpayer's compliance record may be relevant to determining whether he or she acted in good faith. An analysis of reasonableness requires an individual evaluation of each taxpayer seeking relief to determine what could reasonably be expected from him or her under the circumstances. Thus, factors relevant to this analysis may include the taxpayer's level of education, experience, mental and physical impairment, third party bad acts, and the extent to which the IRS's actions or procedures or the tax rules impaired his or her ability to avoid or mitigate the situation. The IRS already conducts such an analysis in providing relief to taxpayers from joint and several liability under IRC § 6015 ("innocent spouse" relief).[53]

[53] *See* Rev. Proc. 2003-61, 2003-32 I.R.B. 296.

HARDSHIP CONSIDERATIONS

PROBLEM

Although IRS will compromise a liability on the basis of an individual taxpayer's "economic hardship," it does not take into account the hardships of third parties, such as the community, employees, customers, and relatives, except perhaps indirectly when the third parties are dependents.[54]

Example 4: Third Party Hardship

A church with a spotless record of tax compliance had an 80-year-old bookkeeper who, after consistently filing and paying payroll taxes for 17 years, failed to file and pay these taxes for the last 22 quarters. After a new bookkeeper discovered the problem, the church filed returns but could not fully pay its delinquent taxes. The church's activities included religious education, youth programs, attending to the elderly, and providing food, shelter and clothing to the needy in a low income community. The church acted reasonably in relying on a bookkeeper with a 17 year history of accurately fulfilling her duties. Full payment of interest and penalties would have jeopardized the availability of the church's programs, potentially resulting in hardship for needy third parties. The church submitted an offer to pay the tax liability, requesting a compromise only of interest and penalties based upon ETA. The IRS did not accept it.[55]

RECOMMENDATION

Add new paragraph 7122(c)(5) of the Code to read as follows:

> "RULES RELATING TO OFFERS BASED UPON HARDSHIP. -- Notwithstanding any other provision of this title, unless the taxpayer has a recent unexplained history of noncompliance with tax filing or payment obligations, the Secretary may compromise a liability if collection of unpaid tax (or any portion thereof, including penalties and interest) would cause a hardship for the taxpayer or for a third party, without regard to whether the taxpayer is a person or an entity. This determination shall be made without regard to the taxpayer's ability to fully pay the liability.

[54] T.D. 9007, 67 Fed. Reg. 48,025, 48,026 (July 23, 2002) (preamble); Treas. Reg. § 301.7122-1(b)(3); Treas. Reg. § 301.6343-1(b)(4); IRM 5.8.11.2.1(5) (Rev. 5-15-2004).

[55] Some penalties and interest may ultimately have been abated in this case. A similar case involved an offer from a small borough to compromise employment tax penalties, the rejection of which was based upon the assumption that borough assets available to pay the tax included a building, office equipment, a playground and a police car.

PRESENT LAW

Historical Background

In 1933, in the wake of the Depression, Acting Secretary of the Treasury Acheson suggested that the IRS should compromise tax claims where collection would "destroy a business, ruin a tax producer, throw men out of employment, or result in the impoverishment of widows or minor children of a deceased taxpayer."[56] Following Attorney General Cummings' response, which indicated the IRS had no such authority, there were calls for Congress to expand IRS' authority to compromise such cases.[57]

Recent Developments

In 1998, Congress clarified that the Secretary had authority to accept "effective tax administration" (ETA) offers to compromise tax liabilities on the basis of "hardship."[58] Under current regulations, this means "economic hardship,"[59] which is defined by reference to the standard used to determine whether IRS should release a levy, *i.e.*, whether collection would leave the taxpayer unable to meet basic living expenses.[60] A nonexclusive list of factors includes:

(A) Taxpayer is incapable of earning a living because of a long term illness, medical condition, or disability, and it is reasonably foreseeable that taxpayer's financial resources will be exhausted providing for care and support during the course of the condition;

(B) Although taxpayer has certain monthly income, that income is exhausted each month in providing for the care of dependents with no other means of support; and

(C) Although taxpayer has certain assets, the taxpayer is unable to borrow against the equity in those assets and liquidation of those assets to pay outstanding tax liabilities would render the taxpayer unable to meet basic living expenses.[61]

Factors such as the taxpayer's age, employment status, and the age, health and employment status of the taxpayer's dependents may also be considered.[62]

[56] *See Op.* Atty. Gen 6, XIII-47-7138 (Oct. 24, 1933), *excerpts reprinted* in TD 8829, 64 Fed. Reg. 39,020, 39,021 (July 21, 1999) (preamble).

[57] *See, e.g.*, American Bar Association Testimony at Senate Hearings before the Committee on Finance on the Revenue Act of 1938, H.R. 9682, 75th Cong., 3rd Sess. (March 17, 1938) at 301-302 (recommending an expansion of IRS's authority to compromise in cases where "although it is possible for the Government to collect its claim in full, the result will be to force the taxpayer out of business with consequent reduction in employment in the community, the loss of a potential source of revenue to the Government, or making the taxpayer a charge on the community for his existence."). As noted above, subsequent analyses have questioned the reasoning of the Cummings opinion. *See* GCM 24147 (August 13, 1942).

[58] IRC § 7122(c); H.R. Conf. Rep. No. 599, 105th Cong., 2nd Sess., 289 (1998).

[59] Treas. Reg. § 301.7122-1(b)(3).

[60] T.D. 9007, 67 Fed. Reg. 48,025, 48,025 (Aug. 20, 2002) (preamble); IRC § 6343(a)(1)(D); Treas. Reg. § 301.6343-1(b)(4)(i).

[61] Treas. Reg. § 301.7122-1(c)(iii); IRM 5.8.11.2.1(6) (Rev. 5-15-04).

[62] Treas. Reg. § 301.6342-1(b)(4)(ii); IRM 5.8.11.2.1(5) (Rev. 5-15-04). As noted above, a general requirement for the acceptance of any ETA offer is that the taxpayer must have a history of tax filing and payment compliance and must not have either taken deliberate actions to avoid the payment of taxes or encouraged others to refuse to comply with the tax laws. Treas. Reg. § 301.7122-1(b)(iii); Treas. Reg. § 301.7122-1(c)(iii); IRM 5.8.11.2.1(7) (Rev. 5-15-04).

Although the IRS tried to develop an economic hardship test that could apply to entities, it abandoned that approach when final regulations were issued based upon concerns that the IRS would be supporting nonviable businesses.[63] Thus, the economic hardship standard applies only to individual taxpayers (and not to third parties or entities).[64] In addition, IRS takes economic hardships which may be experienced by the taxpayer's dependents into account only indirectly by assessing the economic hardship suffered by the taxpayer as a result of having to deplete income to care for dependents with no other means of support.[65] This suggests, for example, that hardships suffered by a taxpayer's nondependent children, employees or customers would not be taken into account.[66]

REASON FOR CHANGE

The IRS' collection actions may disrupt services to customers or create hardships for nondependent children or other third parties, as illustrated in *Example 4*. Under current law, the IRS will not compromise a liability on the basis that collection from an entity would, for example, "destroy a business, ruin a tax producer, [or] throw men out of employment," or otherwise result in hardship for third parties, even though such considerations have historically been associated with the authority to compromise based upon hardship.[67] Although IRS should not compromise a liability that will subsidize a nonviable business at the expense of its competitors on the basis of hardship, the IRS should reasonably consider all of the consequences of collecting the liability in full, including consequences to third parties in determining whether to compromise a liability.

[63] T.D. 9007, 67 Fed. Reg. 48,025, 48,026 (Aug. 20, 2002) (preamble).

[64] Treas. Reg. § 301.6343-1 (defining "economic hardship" by reference to an "individual taxpayer"). An economic hardship example involving an entity was removed from the temporary regulations. T.D. 9007, 67 Fed. Reg. 48,025, 48,026 (July 23, 2002) (preamble).

[65] Treas. Reg. § 301.7122-1(b)(3). Although factors such as the age and health of the taxpayer's *dependents* may be taken into account, IRS has not documented *how* such factors are to be taken into account. Treas. Reg. § 301.6343-1(b)(4); IRM 5.8.11.2.1(5) (Rev. 5-15-2004). Does a taxpayer need to get a doctor's note estimating the total cost of treatment? What if the dependent's expenses are likely to be incurred after they become independent? Although the effect on third parties may be considered in determining which collection alternative to pursue, how such effects are considered is similarly unspecified. IRM 5.10.1.3.2(3) (Rev. 10-1-2004).

[66] However, IRS can sometimes take the support of a dependent that is not claimed as such on his or her tax return (such as a foster child) into account in determining which national expense standard to apply. IRM 5.8.5.5.1(3) (Rev. 11-15-2004).

[67] T.D. 8829, 64 Fed. Reg. 39,020, 39,021 (July 21, 1999) (preamble, quoting Treasury Secretary Acheson's 1933 letter to the Attorney General); Proceedings and Debates, 69th Cong. 1st Sess., Special Session of the Senate Vol. LXVII–Part 1 (Dec. 11, 1925) at 1150 (discussion of an amendment offered by Mr. Breedy for expanding compromise authority because "there is a demand for it by legitimate business and on the part of concerns where to pay the full tax would mean throwing them into bankruptcy"); American Bar Association Testimony at Senate Hearings before the Committee on Finance on the Revenue Act of 1938, H.R. 9682, 75th Cong., 3rd Sess. (March 17, 1938) at 301-302 (recommending an expansion of IRS's authority to compromise).

Although the IRS does not track the number of compromises received or accepted based on economic hardship, anecdotal evidence suggests that IRS has rarely used its authority to compromise on the basis of economic hardship. If true, this may be because IRS employees prefer to compromise hardship cases on the basis of doubt at to collectibility rather than ETA.[68] Since a compromise based upon collectibility is evaluated under the same general standard as "economic hardship," i.e., whether collection would leave a taxpayer without the ability to pay "basic living expenses," the ability to compromise on the basis of economic hardship does not provide the IRS with significantly more authority than they had (or should have had) under preexisting rules.[69]

EXPLANATION OF RECOMMENDATION

Under the proposal, the IRS's authority to compromise based upon "hardship" would be expanded beyond an evaluation of the taxpayer's ability to pay reasonable basic living expenses. The IRS would analyze the facts and circumstances relating to each offer to determine whether collection of the full liability is likely to produce a hardship for the taxpayer or third parties, regardless of whether the taxpayer is an individual or a business entity and regardless of whether the third parties are the taxpayer's legal dependents.[70] In such cases, a compromise would be appropriate unless the taxpayer had a recent unexplained history of noncompliance.[71] The existing "economic hardship" considerations based upon the taxpayer's ability to pay basic living expenses could be incorporated into the analysis of offers based upon doubt as to collectibility.

[68] Although current guidance provides that compromise may not be made on the basis of hardship only if the liability could be collected in full, subjective components of financial analysis sometimes allow IRS employees chose the basis on which an OIC is compromised. Treas. Reg. § 301.7122-1(b)(3)(i).

[69] Treas. Reg. § 301.7122-1(c)(2)(i) (permitting taxpayers to "retain sufficient funds to pay basic living expenses" in connection with offers based on doubt as to collectibility); Treas. Reg. § 301.7122-1(b)(3)(1) (using the "economic hardship" standard under IRC § 6342 for ETA); Treas. Reg. § 301.6343-1(b)(4) (defining "economic hardship" as the inability to pay "reasonable basic living expenses").

[70] Since entities are intangible, the hardship experienced by an entity could be measured by reference to the cumulative effect that collection would have on the entity's employees, customers, suppliers, owners, and community.

[71] Concern about unfair advantage or abuse of process are overcome by the fact that to get ANY offer accepted, the taxpayer must agree to remain compliant for five years and if he does not the compromised liability will be fully reinstated. Form 656, Offer in Compromise (Rev. 7-2004) (item 8(d)).

OFFER PROCESSING ORDER

PROBLEM

An offer in compromise (OIC) can be submitted on the basis of "doubt as to collectibility" (DATC), "doubt as to liability" (DATL), or in furtherance of "effective tax administration" (ETA), or any combination of these bases.[72] In considering combination offers, the IRS always determines what it could collect before it determines how much the taxpayer owes or whether compromise based upon equity/public policy ETA considerations is appropriate.[73] Consider the following hypothetical example:

EXAMPLE

A taxpayer is subject to a $10,000 assessment for a trust fund recovery penalty resulting from unpaid business employment tax liabilities. A bookkeeper embezzled the business' payroll tax deposits and was recently convicted for that crime. The taxpayer believes that although he cannot pay the assessed liability, he actually owes nothing (*e.g*, because he is not a "responsible person"), and even if he does owe the tax it would be inequitable to collect any such liability from him given the intervening bad act. He hires a tax advisor to help him submit an OIC for $1 based upon DATL, DATC, and ETA along with the $150 fee. The taxpayer fails to sufficiently document certain expenses and does not receive the IRS' communication requesting additional documentation in time to respond. After two months, the offer is returned with the IRS retaining the fee. One month later, the taxpayer submits the offer again with updated financial information. In accordance with its procedures, the IRS first conducts a financial analysis, and within six months determines that the taxpayer can pay only $3,000. Given the risk that the DATL and ETA issues would not be resolved in the taxpayer's favor after another long wait and that he might have to submit another offer and financial analysis to resolve the liability for only $3,000, the taxpayer who has spent more than a thousand dollars (in OIC processing fees and tax advisor fees) to submit the offer, decides to agree to pay $3,000 to resolve the matter.

RECOMMENDATION

Add new sub-paragraph 7122(c)(3)(C) of the Code to read as follows:

> "in the case of an offer-in-compromise submitted on more than one basis, the Secretary shall evaluate the taxpayer's bases for compromise in the order indicated by the taxpayer, and the Secretary's decision to compromise on one basis shall not depend on whether the Secretary would be willing to compromise on another basis; and"

[72] IRM 5.8.4.10(1) (Rev. 11-15-2004).

[73] IRM 5.8.4.10(3) (Rev. 11-15-2004); Treas. Reg. § 301.7122-1(b)(3)(ii).

[74] Treas. Reg. § 301.7122-1(b)(3). Similarly, an ETA offer based on hardship may only be considered after it is determined that the liability could be collected in full, i.e., that DATC does not exist. *Id.* However, an ETA offer based on hardship could be accepted without a determination that DATL does not exist.

[75] IRM 5.8.4.10(3) (Rev. 11-15-2004).

PRESENT LAW

No statutory provision governs the order in which combination offers are processed. Current regulations provide that an offer may not be considered on the basis of non-hardship ETA if DATC or DATL exist.[74] Internal Revenue Manual procedures provide that when an OIC is submitted on more than one basis, DATC issues will be processed first, followed by DATL issues, and only after DATC and DATL have been considered and rejected will an equity or public policy offer based on ETA be considered.[75] An OIC may be returned based upon a failure to provide financial information that is relevant only to DATC issues even if it is also submitted on the basis of DATL or ETA.[76] If the offer is accepted on the basis of DATC, neither DATL nor ETA is considered.[77]

REASON FOR CHANGE

Under current procedures, taxpayers that submit combination offers must wait for IRS to analyze their personal financial information before the IRS will consider whether they owe the tax or whether the tax should not be collected based upon equitable considerations. This is unnecessarily burdensome for both the IRS and for taxpayers. If a taxpayer fails to provide sufficient and timely documentation of financial information, IRS may return the entire offer without considering whether the taxpayer actually owes the tax or whether it would be inequitable for the IRS to collect it, even though the taxpayer's financial condition may not be relevant to IRS' consideration of those issues.

EXPLANATION OF PROVISION

Under the proposal, when an OIC is submitted on more than one basis, the taxpayer has the opportunity to select the order in which the bases will be considered. A taxpayer faced with a liability that is not properly due or that it would be inequitable to collect will be able to get his or her offer accepted on those bases without the delay of having the IRS first consider whether compromise on another basis would be possible.[78] Since a taxpayer's financial information is relevant only to collectibility or hardship issues, offers would not be returned based on a lack of financial information unless the IRS is actually considering a compromise on those bases. Unless a taxpayer requested DATC issues to be considered before DATL issues, they would not be faced with the choice of compromising for more than the correct amount of tax to resolve the matter or waiting for IRS to complete the DATL analysis.[79]

---

[76] IRM 5.8.4.10(4) (Rev. 11-15-2004).

[77] *Id.* Item 8(l) on Form 656 prohibits taxpayers from contesting the liability "in court or otherwise." However, once IRS determines to accept a combination offer based on DATC, they will now give the taxpayer the option to either take the DATC offer or to pursue the DATL issues. Memorandum from Director, Collection Policy regarding Processing Changes for Offers in Compromise Submitted as Doubt as to Collectibility (DATC) and Doubt as to Liability, November 17, 2004.

[78] Once a basis for compromise is found the IRS would retain the ability to consider all relevant factors in determining whether an offer amount is acceptable. Treas. Reg. § 301.7122-1(c)(1).

[79] Although some taxpayers could submit DATL or ETA offers raising frivolous issues for purposes of delay and request that those issues be decided first, the IRS would retain the ability to summarily return or reject such offers. In addition, Congress has been considering enhanced penalties and procedures to deal with frivolous offers. *See* Tax Administration Good Government Act, S. 882, 108th Cong. § 209 (2003).

6 COLLECTION DUE PROCESS HEARINGS

PROBLEM

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)[1] established Collection Due Process (CDP) hearing rights under Internal Revenue Code (IRC) sections 6320 (liens) and 6330 (levies).[2] By creating informal due process procedures for taxpayers prior to the IRS taking collection action, Congress moved to afford taxpayers the type of protections they would receive in dealing with any creditor.[3]

Since its enactment, CDP has been the subject of much debate. Opponents of the process, both inside and outside the IRS, decry CDP hearings as a waste of taxpayer, IRS, and judicial time and resources.[4] Proponents, on the other hand, maintain that CDP hearings afford taxpayers an opportunity to be heard before or immediately after collection is initiated and, through the mechanism of judicial review, ensure that the Service's procedures conform to notions of fairness and due process.[5]

The National Taxpayer Advocate believes that CDP is a much-needed safeguard and taxpayer protection, given the Internal Revenue Service's unrivaled powers as a creditor. She also acknowledges that both legislative and administrative improvements to the CDP hearing process are warranted. The National Taxpayer Advocate makes the following recommendations:

- Retain the Collection Due Process procedure as a necessary, essential, and statutory taxpayer right.
- Amend IRC § 6330(d) to limit judicial review to issues other than the existence or amount of the tax liability underlying the collection action. Continue to allow taxpayers to raise challenges to the existence or amount of the underlying tax liability at the Appeals' hearing level, pursuant to present law under IRC § 6330(c)(2)(B).[6]

[1] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206.

[2] *Id.*, § 3401, 112 Stat. 685.

[3] S. Rep. No. 105-174, 105th Cong., p. 67 (1998); Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1999*, 81 and 83 (JCS-6-98).

[4] For a thoughtful and lucid statement of this perspective, *see* Bryan T. Camp, "The Inquisitorial Process of Tax Administration," *Tax Notes*, June 21, 2004, 1549; Bryan T. Camp, "The Failure of Collection Due Process, Pt. 1," *Tax Notes*, Aug. 30, 2004, 969; .Bryan T. Camp, "The Failure of CDP, Part 2: Why It Adds No Value," *Tax Notes*, Sept. 27, 2004, 1567; and Bryan T. Camp, "The Costs of CDP," *Tax Notes*, Dec. 6, 2004, 1445.

[5] For a detailed analysis of IRS collection activities and Collection Due Process in the context of constitutional and administrative due process protections, *see* Leslie Book, *The Collection Due Process Rights: A Misstep or Step in the Right Direction?*, 41 Houston L. Rev. (forthcoming 2005) (copy on file with Office of the Taxpayer Advocate).

[6] Since we also recommend that the liability determination should play into the "balancing" part of the Appeals Hearing Officer's analysis and determination, the court would still undertake an "abuse of discretion" review of liability determinations when it reviews the decision to allow collection to proceed.

- Amend IRC § 6330(c)(2)(B) to provide that, regardless of whether the taxpayer actually received a statutory notice of deficiency, had an opportunity to dispute such liability, or self-assessed the liability on a tax return, the taxpayer may raise issues relating to the existence or amount of any liability that is eligible for an audit reconsideration or a Doubt as to Liability Offer in Compromise. Amend IRC § 6330(c)(3)(C) to provide that the Office of Appeals shall not issue a Notice of Determination in said case until such reconsideration and administrative appeal of the underlying liability has been concluded and the results taken into consideration in making the determination under that paragraph.[7]
- Amend the flush language of IRC § 6320(a)(2) to provide that the Secretary shall send the notice required under IRC § 6320(a)(1) not more than five business days after the day the notice of lien is mailed or otherwise submitted for filing. Further, amend IRC § 6320(a)(3)(B) to provide that the taxpayer has 30 days from date the notice is provided under IRC § 6320(a)(2) to request a hearing.

The National Taxpayer Advocate makes the following administrative recommendations:

- The Office of Appeals should clearly inform taxpayers that they are entitled to face-to-face hearings in cases raising the appropriateness of collection alternatives, unless they elect out of a face-to-face hearing or raise only frivolous issues prior to the hearing.
- The Office of Appeals should clearly inform taxpayers that where they are entitled to a face-to-face hearing, they have the right to record such hearing at their expense.
- The Office of Appeals should develop a separate form that is sent to each taxpayer with acknowledgement of the CDP hearing request, setting forth all collection alternatives to lien and levy actions (including subordination, partial discharge, and withdrawal of lien, full and partial pay installment agreements, offers in compromise, currently not collectible status, and grounds for penalty and interest abatement) and instructing the taxpayer to identify all relevant collection alternatives and supporting facts on the form provided.

[7] The National Taxpayer Advocate suggests that, unless the taxpayer objects, the Appeals Hearing Officer, if qualified and knowledgeable in the matter at issue, should be able to act as the Appeals Settlement Officer if a taxpayer appeals the audit reconsideration or offer in compromise during a CDP hearing. Of course, taxpayers must be clearly told that they have the right to object.

EXAMPLE

Taxpayer A ran a small business that sustained severe fire damage in 2000. In 2002, the IRS audited Taxpayer A's return, including his Schedule C, Profit or Loss from Business (Sole Proprietorship), for the year of the fire. Taxpayer A was unable to provide documentation in support of most of his busines expenses because many of his books and records were destroyed in the fire. The IRS disallowed all business expenses claimed on the Schedule C. Because Taxpayer A was struggling to save his failing business, he did not request an Appeals conference or timely file a petition in the United States Tax Court in response to Notice of Deficiency, that he received. The IRS then assessed $7,000 in additional income and self-employment tax.

Taxpayer A has tried to explain to IRS collection personnel that he does't owe this tax because he had legitimate business expenses, but he has not been successful in getting anyone to listen to him. The IRS is now proposing to levy on his paycheck and issued a Notice of Intent to Levy and Right to Collection Due Process Hearing.

Taxpayer A timely filed a request for a CDP hearing and has tried to prove to the Appeals Officer that the underlying liability is erroneous. Because Taxpayer A actually received the Notice of Deficiency, the Appeals Officer will not consider the underlying liability at the hearing. The Appeals Officer issues a determination letter sustaining the IRS' proposed levy action and triggering the 30-day period for Taxpayer A to petition the United States Tax Court. However, the Appeals Officer has said she will suspend the collection action while Taxpayer A seeks an audit reconsideration from the IRS, which could take up to 6 months. Taxpayer A will probably file a petition in Tax Court because he does not want to lose his appeal rights, even though he thinks he could resolve the matter in audit reconsideration.

PRESENT LAW

The Collection Due Process legislation was enacted with the goal of establishing "formal procedures designed to ensure due process where the IRS seeks to collect taxes by levy (including by seizure)."[8] The legislation affords taxpayers the opportunity to ask for a meaningful review of certain IRS collection actions, by an impartial officer of the IRS' Office of Appeals, at two separate points in the collection process: after the filing of a Notice of Federal Tax Lien (NFTL) and prior to a levy of the taxpayer's property.[9] At both steps, the IRS must send a notice to the taxpayer's last known address by certified or registered mail, providing the taxpayer an opportunity to request a CDP hearing.[10] A taxpayer who desires a hearing must request one in writing within 30 days of the date of the notice.[11] If the taxpay-

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

[9] IRC § 6320(b) governs a taxpayer's rights to a CDP hearing after the filing of a federal tax lien, and IRC § 6330(b) governs a taxpayer's rights to a CDP hearing prior to the levy of the taxpayer's property.

[10] IRC §§ 6320(a)(2)(C) and 6330(a)(2)(C). The IRS may also give the notice in person or leave the notice at the dwelling or usual place of business of such person. IRC §§ 6320(a)(2)(A) and (B); IRC §§ 6330(a)(2)(A) and (B).

er makes an untimely request, the Office of Appeals will hold an "equivalent hearing" which resembles a CDP hearing in all respects except that no judicial review is available.[12]

The term "hearing," as defined by the Treasury Regulations, does not necessarily guarantee the taxpayer an opportunity to appear face-to-face before an IRS representative. The regulations suggest that a mere exchange of correspondence may constitute a hearing.[13] However, the Treasury Regulations indicate that a face-to-face hearing will be granted if the taxpayer specifically makes such a request.[14]

At the hearing, the taxpayer may raise one or more of the following issues relating to the unpaid tax:

- Appropriateness of collection actions;[15]
- Collection alternatives such as installment agreement, offer-in-compromise, posting a bond or substitution of other assets;[16]
- Appropriate spousal defenses;[17] and
- The existence or amount of the tax, but only if the taxpayer did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the tax liability.[18]

The Appeals Officer conducting the hearing must also obtain verification from the IRS that all requirements of applicable laws and administrative procedures were, in fact, satisfied.[19]

After the hearing, the Office of Appeals issues a Notice of Determination that sets forth

[11] IRC §§ 6320(a)(3)(B) and 6330(a)(3)(B); Treas. Reg. §§ 301.6320-1(c)(2), Q&A-C1 and 301.6330-1(c)(2), Q&A-C1.

[12] Treas. Reg. §§ 301.6320-1(c)(2), Q&A-C7 and 301.6330-1(c)(2), Q&A-C7.

[13] Treas. Reg. §§ 301.6320-1(d)(2), Q&A-D6 and 301.6330-1(d)(2), Q&A-D6.

[14] Treas. Reg. §§ 301.6320-1(d)(2), Q&A-D7 and 301.6330-1(d)(2), Q&A-D7.

[15] IRC § 6330(c)(2)(A)(ii).

[16] IRC § 6330(c)(2)(A)(iii).

[17] IRC § 6330(c)(2)(A)(i).

[18] IRC § 6330(c)(2)(B). The taxpayer may not reintroduce an issue that was raised and considered at a prior administrative or judicial hearing, if the individual participated meaningfully in the prior hearing or proceeding. IRC § 6330(c)(4).

[19] IRC § 6330(c)(1).

the findings and determinations on the issues raised by the taxpayer.[20] In making his or her determination, the Appeals Officer must take into consideration the verification that all applicable law and administrative procedures were followed; the issues raised by the taxpayer at the hearing; and "whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary."[21]

Depending on the type of tax at issue, the taxpayer can appeal the Notice of Determination to the United States Tax Court or the appropriate United States district court.[22] Except in limited circumstances, the standard of review for courts reviewing the actions of Appeals officers, including the findings of fact set forth in the Notice of Determination, is an "abuse of discretion" standard.[23] This means the reviewing court will not overturn the action of the Appeals Officer unless the court determines he or she has acted arbitrarily or acted without a sound basis in fact or law.[24] In contrast, the *de novo* standard of review allows the reviewing court to reach its own conclusions about disputed facts without affording deference to the findings of the Appeals officer.[25] However, courts that hear appeals from CDP hearings use the *de novo* standard in certain circumstances, such as where the taxpayer is able to dispute the underlying tax liability.[26]

REASONS FOR CHANGE

Why Collection Due Process?

The Internal Revenue Service's collection powers are unrivalled in the United States. They are triggered either by the taxpayer's own failure to pay the tax due according to his or her own self-assessment, by a summary assessment of tax under the Service's "math error" authority, by jeopardy assessment or by administrative or judicial proceedings to determine a deficiency in tax in which the government enjoys the presumption of correctness. Once any of these events has occurred, the IRS merely needs to send a notice of tax due and demand for payment before it can take administrative levy and lien actions

[20] Treas. Reg. §§ 301.6320-1(e)(3), Q&A-E8 and 301.6330-1(e)(3), Q&A-E8.

[21] IRC § 6330(c)(3).

[22] IRC § 6330(d)(1).

[23] *Goza v. Comm'r*, 114 T.C. 176 (2000) (court reviews administrative determinations for abuse of discretion if the underlying liability is not at issue).

[24] *Woodral v. Comm'r*, 112 T.C. 19, 23 (1999); *Fargo v. Comm'r*, T.C. Memo. 2004-13; *Razo v. Comm'r*, T.C. Memo. 2004-101.

[25] The phrase "*de novo*" means anew, *Black's Law Dictionary* 447(7th ed. 1999); *see also Woodral v. Comm'r*, 112 T.C. 19, 23 (1999); *Fargo v. Comm'r*, T.C. Memo. 2004-13; *Razo v. Comm'r*, T.C. Memo. 2004-101.

[26] IRC §§ 6320(c) and 6330(c)(2)(B) provide that the taxpayer may contest the underlying liability if the taxpayer did not receive a notice of deficiency and did not otherwise have an opportunity to contest the underlying tax liability; *see Montgomery v. Comm'r*, 122 T.C. No. 1 (2004), where the United States Tax Court held that a taxpayer is able to dispute the underlying tax liability at a CDP hearing even where the tax was self-assessed.

that any other creditor would have to obtain a judgment for prior to collecting.[27]

While the vast majority of U.S. taxpayers timely file and pay their taxes, there are always some taxpayers who either cannot or will not pay their taxes. Within the "cannot" category, some taxpayers do not know that the tax is due or believe that the IRS was incorrect in assessing the tax; others know that they owe taxes but are not able to pay the amount due without some financial injury. Moreover, among those taxpayers who believe that they will be harmed financially if they pay all or even part of the tax due, there is a wide spectrum of opinions about what constitutes economic harm. Should all U.S. taxpayers underwrite someone's college education at an Ivy League university or tithes to a religious institution? Or should economic harm be limited to a taxpayer's ability to put food on the table and a roof over his or her head?

In addition to addressing these challenges, the IRS must decide precisely how it will collect outstanding taxes. Upon issuance of the "Notice and Demand" letter, the IRS can file a Notice of Federal Tax Lien without any additional judicial scrutiny. Moreover, upon 30 days notice of its intent to levy, the Service can levy on taxpayer wages, bank and securities accounts, Social Security and other retirement benefits, and seize tangible property.[28] Indeed, the IRS's reach as a creditor extends to "all property and rights to property, whether real or personal, belonging to such person."[29] Even property transferred by the taxpayer to a third party is not beyond the IRS' reach except in certain circumstances.[30] Given these awesome powers, which of the taxpayer's assets or income sources shall the IRS go after?

These are just a few of the very difficult decisions that the IRS must make in hundreds of thousands of collection cases each year. Clearly the IRS cannot make individualized decisions in all of these cases. In fact, the IRS has developed automated and batch processing procedures in the Automated Collection System, which notifies taxpayers about their tax debts through a sequence of notices and ultimately seeks out levy sources or files Notices of Federal Tax Liens against most of the taxpayers who are unresponsive to the notice sequence. Only a subset of taxpayers, based on considerations of type and amount of tax debt, are referred to the Collection Field function (CFf) for assignment to Revenue Officers (ROs).

[27] *See* IRC § 6303, see also *Bull vs. United States*, 295 U.S. 247, 260 (1935) (the assessment process works a "reversal" of the normal collection process, in that payment precedes defense).

[28] IRC § 6331(d)(2).

[29] IRC § 63211.

[30] *See* IRC § 6323.

Collection employees daily determine how to wield the IRS's extraordinary collection power. Prior to the enactment of RRA 98, there were very few checks on this authority. Indeed, the United States Supreme Court has held over and over that, where taxes are concerned, the government need only satisfy the constitutionally minimum due process requirements with respect to seizing a taxpayer's property.[31] This extraordinary deference was justified by the notion that "taxes are the lifeblood of government"[32] and therefore the government must be able to proceed to collect what it needs for its existence without undue delay.

In RRA 98, however, Congress modified this approach a bit. Leading up to RRA 98's enactment, both chambers of Congress heard testimony about problems with the way the IRS operated from taxpayers, practitioners, former Commissioners of Internal Revenue, other government officials, tax professional groups, academics and policy wonks, and also received a comprehensive report from the National Commission on Restructuring the IRS.[33] Much attention has been paid to a few sensational testimonials by taxpayers, several of which turned out to be not quite accurate. But a close reading of the *entire* body of hearings shows that extremely thoughtful and experienced tax professionals and policymakers directed their best efforts to the tax system and tried to diagnose its problems and suggest possible solutions. That not all of the adopted proposals turned out to be flawless should be no surprise, but this does not diminish the serious and honest effort that went into improving the tax system in the years leading up to and immediately following RRA 98's enactment.

Among other things, Congress created the procedure known as Collection Due Process. It stemmed from the notion "the IRS should afford taxpayers adequate notice of collection activity and a meaningful hearing *before* the IRS deprives them of their property."[34] (Italics added.) That is, in enacting the CDP provisions, Congress was concerned that the current state of affairs provided taxpayers with insufficient protections. Critics argue that CDP hearings do not solve this problem and instead create many others for the collection process.[35] Within the IRS, many IRS officials charge that CDP has almost single-handedly brought collection to a standstill. It is appropriate to ask whether CDP actually provides taxpayers with the intended protections or instead thwarts the legitimate collection of tax.

Does CDP Provide the Protections It Was Designed to Address?

31 *See, e.g., Phillips v. Comm'r*, 283 U.S. 589 (1931).

32 As the Supreme Court has said "taxes are the lifeblood of government, and their prompt and certain availability an imperious need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection…[therefore] the statutes, in a spirit of fairness, invariably afford the taxpayer an opportunity at some stage to have mistakes rectified." *Bull v. US*, 295 U.S. 247, 259-260 (1935).

33 *See generally*, Report of the Commission on Restructuring the Internal Revenue Service: *A Vision for a New IRS: Report of the National Commission on Restructuring the Internal Revenue Service*, June 25,1997; *Hearings on Taxpayer Rights Proposals and Recommendations of the National Commission on Restructuring the Internal Revenue Service on Taxpayer Protections and Rights Before the Subcommittee on Oversight of the House Comm. on Ways and Means*, 105th Cong., 1st Sess., Sept. 16,17, and 26, 1997; *Hearings on H.R. 2676 Before the Senate Comm. On Finance*, 105th Cong., 2d Sess., Jan. 28, 29, Feb. 5, 11, and 25, 1998.

34 S. Rep. No. 105-174 at 67.

35 *See generally*, Bryan T. Camp, "The Costs of CDP," Tax Notes, Dec. 6, 2004, 1445.

One purpose of the collection process is for the IRS and ACS to "acquire the information necessary to make a classification" about whether the taxpayer fits into one of three categories – will pay, won't pay, or can't pay.[36] In a perfect world, it is fine to talk about taxpayers being under an obligation to come forward and explain why they do or don't owe taxes, or why they can't pay. But we don't live in a perfect world. We live in a world where perfectly intelligent and honest people quake when they get a letter from the IRS and where a subset of taxpayers with collection problems may be illiterate or have limited English proficiency.[37] Moreover, we live in a world where the IRS designs its systems and procedures so that many of its collection, examination, and accounts management employees are not able to pick up the phone and call taxpayers to discuss their cases.[38]

At its RRA 98 hearings, the Senate Finance Committee heard testimony about how difficult it was to get collection personnel to stop and listen to taxpayers who were saying, "I don't owe this tax," or "Don't file that lien – it will make it impossible for me to borrow to pay the tax."[39] This difficulty occurred in both ACS and CFf functions. With ACS, because of its automated nature, it was virtually impossible to get anyone to pay attention to the taxpayer much less transfer the case to audit reconsideration or discuss a collection alternative other than an installment agreement or currently not collectible status. Given the pressure ROs were under to close cases and not lose control of cases, collection actions proceeded even as taxpayers requested audit reconsideration.

In making collection decisions, the IRS has lots of incentive to make the right call about which "box" – will/can't/won't pay – the taxpayer fits in. No one wants to take a collection action that will deliberately harm the taxpayer, and IRS employees are trained to make the distinction between taxpayers genuinely attempting to resolve their tax problems and those who are actively ignoring, avoiding, or even evading their tax liabilities.

But IRS systems and directives often undermine this training. For example, IRS has a relentless need to demonstrate to both the executive and legislative branches that it is collecting tax in the least costly and efficient manner possible, in terms of absolute dollars and direct time on cases. It also must show that it is back on the enforcement beat by fil-

[36] Bryan T. Camp, "The Failure of CDP, Part 2; Why It Adds No Value," *Tax Notes*, Sept. 27, 2004, 567.

[37] Twenty-five percent of the U.S. taxpayer population in 2000 is intimidated by the IRS and another 41 percent is distrustful of the IRS. Russell Marketing Research, *Findings from Task 149 – The Taxpayer Advocate Service Research Program, With a Focus on the Detailed Study of the Underserved Segment, Phase II, Study #3* (July 2002) at 21.

[38] For an analysis of the impact that IRS-initiated telephone contact can have on taxpayers' ability to obtain the Earned Income Tax Credit, *see* the National Taxpayer Advocate, *Annual Report to Congress Volume II, The National Taxpayer Advocate's Earned Income Tax Credit (EITC) Audit Reconsideration Study*, December 2004.

[39] *See*, generally, *Hearings on H.R. 2676 Before the Senate Comm. On Finance*, 105th Cong., 2d Sess., Jan. 28, 29, Feb. 5, 11, and 25, 1998 (statements of Robert S. Schriebman, Michael I. Saltzman, David A. Keating, and Nina E. Olson).

ing more liens and issuing more levies than in prior years. While each of these may be legitimate goals, these needs also have the potential to create an atmosphere in which it is more important to reduce your cycle time on a case than to spend the time necessary to determine whether the taxpayer fits into the a can't-pay or won't-pay category. And without proper and due process, an incorrect taxpayer classification – whether intentional or inadvertent or process-driven – can have disastrous consequences for the taxpayer, given the extraordinary collection powers granted to the IRS.

This is where CDP hearings come into play. They were designed to provide the taxpayer with one opportunity to have an independent third party look at the first proposed levy action or the first actual Notice of Federal Tax Lien filing with respect to any tax period liability. Certainly, one can make a case for CDP hearings to occur later in the collection process, after the IRS has taken various collection actions and the taxpayer is particularly aggrieved. By placing CDP hearings at the beginning of the collection process and providing no opportunity for judicial review of most later collection actions, Congress arguably left the taxpayer without protection for later IRS missteps. But there are several protections available for taxpayers in the unfolding collection process, including the Collection Appeals Program (CAP),[40] the ongoing jurisdiction by Appeals of collection actions in CDP cases,[41] and the availability of an "equivalent hearing" where the taxpayer has missed the opportunity to file a formal CDP hearing request.[42] Moreover, at the same time Congress created CDP hearings, it strengthened the authority and independence of the Office of the Taxpayer Advocate and expanded the relief available under Taxpayer Assistance Orders.[43]

In light of these "downstream" protections, providing a CDP hearing at the beginning of the collection process makes sense. It provides the taxpayer with a formal opportunity to protest the will/can't/won't pay classification and to achieve some type of resolution very early in the tax dispute. It makes the IRS pay attention to the taxpayer's position that the lien just filed impairs the taxpayer's ability to resolve the tax. It forces the IRS to consider whether the taxpayer even owes the tax. Who really cares if the taxpayer has had several opportunities to protest the liability and misses them – if the taxpayer is before us now, do we really want to collect a tax that is not, in fact, due? As we have shown above, the competing pressures on both ACS and CFf do not create appropriate incentives for collection employees to learn vital information about taxpayers that might impact the collection determination. The CDP hearing is the one point when things stop and an independent third party takes a look at what is going on.

It is true that CDP stops collection in its tracks. That is the point of CDP. CDP gives the

[40] IRM 5.1.9.4.

[41] IRC § 6330(d)(2).

[42] Treas. Reg. §§ 301.6330-1(i) and 301.6320-1(i).

[43] *See* IRC §§ 7803 and 7811; *see also* S. Rep. No. 105-174 and H.R. Conf. Rep. No. 105-599.

taxpayer a chance to have someone review the IRS' "won't pay" determination. Often Appeals Officers are more helpful and successful in eliciting information from and conversing with the taxpayer than ACS employees. Appeals Officers are certainly less intimidating than ROs. So the CDP hearing may be the first time that the IRS even sees certain information from the taxpayer. This is very similar to what happens in Tax Court cases originating from the correspondence examination function. Because of the automated and batch processing nature of these cases, and taxpayers' own "ostrich-like" behavior, taxpayers often get a Notice of Deficiency and petition the Tax Court without having given the IRS any information. The Appeals Officer or Chief Counsel attorney is often the first person to see any information relating to the proposed liability. Taxpayers in CDP hearings exhibit the same behavior. The only difference is that it is occurring in a collection context, which heretofore has operated without any external interference.

So what, really, is the effect of inserting this administrative and judicial oversight into the tax collection process? Well, here are some statistics relating to CDP hearings:

- As Table 2.6.1 demonstrates, only 1.07 percent of all CDP Levy Notices and 1.77 percent of all CDP Lien Notices issued in Fiscal Year 2004 resulted in CDP Hearing requests received in Appeals.[44]
- Under the IRS' own internal procedures, a taxpayer who timely files a CDP hearing request may have to wait up to 120 days before receiving any acknowledgement or communication from the Office of Appeals about the CDP hearing request.[45]
- Appeals customer satisfaction data indicates that customers are least satisfied with the length of the Appeals process.[46]
- 182 CDP cases were litigated in the federal courts with decisions published by the courts between June 1, 2003, and May 31, 2004, a nine percent decrease from the 199 cases litigated in the previous 12 months. *More importantly, the percentage of litigated CDP cases involving frivolous issues declined from 52 percent (103 cases) in the previous year to 23 percent (42 cases) in the current year.*[47]

[44] Internal Revenue Service, *Collection Due Process (CDP) Talking Points for Group Managers*. In this document, the IRS SB/SE Office of Compliance Policy states that "[when] the CDP provisions were first implemented in 1999, the thought was that most taxpayers, given the opportunity, would request a CDP hearing. After five years experience, the high rate of appeal initially anticipated has not materialized."

[45] IRM §§ 8.7.2.3.2(1) and 5.1.9.3.5.

[46] Pacific Consulting Group, Internal Revenue Service Customer Satisfaction Survey, Appeals National Report, covering April through September 2003, with year-to-date results issued January 2004.

[47] For a detailed analysis of CDP litigation, see Most Litigated Issue: Collection Due Process *infra*. The criteria used to identify a case as frivolous were: (1) an IRC § 6702 penalty (commonly referred to as frivolous return penalty) upheld by the court, (2) an IRC § 6673 sanction asserted by the Tax Court (or Appeals Court), or (3) the court labeling as frivolous the arguments presented by the taxpayer.

TABLE 2.6.1, COLLECTION DUE PROCESS – FY 2004[48]

IRC § 6320 - Lien	NFTLs Filed	CDP Lien Requests*	% of CDP Requests
ACS	280,284	6,925	2.47%
CFf	257,539	2,612	1.01%
Total	**537,823**	**9,537**	**1.77%**
IRC 6330 - Levy	**CDP Levy Notices**	**CDP Levy Requests***	**% of CDP Requests**
ACS	1,628,467	13,951	.86%
CFf	110,394	4,645	4.21%
Total	1,738,861	18,596	1.07%
Grand Total	**2,276,684**	**28,133**	**1.24%**

* Number of CDP requests received in Appeals during FY 2004

Taking all of these facts into consideration, the National Taxpayer Advocate is hard-pressed to see how the IRS can say that CDP wastes resources or causes delay. When only 1.24 percent of all taxpayers receiving these notices actually avail themselves of hearings, and only 182 cases are actually litigated in a year, and of those cases, several involved significant holdings pertaining to the rights under these procedures, CDP does not appear to be the cause of the breakdown in the collection process. Instead, CDP appears to be, for the most part, elected by taxpayers that are genuinely trying to resolve their collection problems.

In fact, the system is operating exactly as any due process review should. The vast majority of taxpayers work with the IRS or do not object to collection actions; but for those few taxpayers who do object, CDP is there. And for those still fewer taxpayers in which the IRS has abused its discretion, there is a system of both administrative and judicial review that provides a check on the IRS and makes sure it learns from those mistakes. The National Taxpayer Advocate believes that the United States tax system can well accommodate this minor cost and inconvenience in light of the significant protections afforded by CDP oversight. This is particularly true in an era of increasing "enforcement" activity, including the use of private collection agencies (PCAs) to collect the tax.

EXPLANATION OF PROPOSALS

For all the reasons set forth above, the National Taxpayer Advocate recommends that CDP Hearings be retained. She acknowledges, however, that the program can certainly be improved, both legislatively and administratively. Several proposals for such improvement are discussed below.

Legislative Recommendations

Judicial Review of Underlying Liability

The National Taxpayer Advocate admits to being surprised by CDP's provision of "back door" access to the Tax Court on liability issues. Certainly, both before and during her

[48] *IRS Collection Due Process, Talking Points for Group Managers.*

tenure as the National Taxpayer Advocate, she has seen numerous cases in which the taxpayer was eligible for an audit reconsideration and even an administrative appeal (or Doubt as to Liability offer in compromise) and the IRS was determinedly, and for no good reason, refusing to provide such relief. But in these situations, the taxpayer now has access to the Taxpayer Advocate Service and the Taxpayer Assistance Order, which can make the IRS provide such a review in appropriate cases. Providing a second opportunity to go to court to a taxpayer who, for whatever reason, has already had one opportunity to challenge the underlying tax liability in Tax Court and missed it, diminishes the meaning of the Notice of Deficiency and pre-assessment review

Where the IRS is proposing to collect a tax that the taxpayer believes he or she does not owe, a better approach is to permit the taxpayer to raise underlying liability issues at the Appeals CDP hearing. If the taxpayer meets the criteria for receiving an audit reconsideration (regardless of whether the taxpayer had an opportunity to raise the issue earlier), the Appeals Hearing Officer should suspend the CDP hearing and forward the issue to the examination function for review.[49] Once the examination function makes its decision, the Appeals Hearing Officer could put his or her Settlement Officer hat on and review the decision, if the taxpayer wants to appeal the finding.[50]

Once all examination issues are laid to rest, the Appeals Officer (wearing his or her Hearing Officer hat again) could conduct the balancing of interests in determining the collection alternatives. Upon the Appeals Officer issuing the Determination Letter, the taxpayer could seek judicial review of the determination. Although there would be no *de novo* judicial review of the underlying tax liability, the court could look at the adequacy of the Hearing Officer's consideration of the underlying liability when it reviews, under an abuse of discretion standard, the Hearing Officer's "balancing" analysis and the decision to allow collection to proceed.

Under this proposal, in those few cases that trigger CDP hearing rights, taxpayers will be assured that collection will only proceed for the correct liability. It may end up that there is no collection liability after the audit reconsideration decision, or that the taxpayer is able to pay the revised tax liability in full. Presently, the Office of Appeals has instructed its employees to issue Hearing Determination Letters sustaining, modifying, or rescinding the proposed collection action and starting the 30-day interval within which a taxpayer must petition the court for judicial review. It then sends the case over to audit reconsideration.[51]

[49] Appeals should enter into a Service Level Agreement with the various IRS examination functions to ensure prompt handling of these cases while the CDP hearing is suspended.

[50] The taxpayer should be given the option of having a different Appeals Officer review exam's decision in certain circumstances. This may be appropriate where the underlying tax issue is beyond the expertise of the CDP Hearing Officer. It is anticipated, however, that most taxpayers will find it expedient to have the Hearing Officer also review the exam decision.

[51] IRS, Office of Appeals, *Liability Guide on CDP Cases*.

This current approach is completely backwards – it results in the Hearing Officer making a collection determination about a liability that might not even exist, and it puts the taxpayer in a position of choosing between going to audit reconsideration or filing in the court. The only rationale for this illogical approach is that Appeals is trying to reduce the cycle time of cases in Appeals. Ironically, this approach ends up increasing cycle time of the case from the taxpayer's, IRS', and court's perspective, because it does not fully resolve the dispute when there is an opportunity to do so.

Period for Taxpayer Response to CDP Lien Hearing Notice

Internal Revenue Code section 6320(a)(2) provides that the Secretary shall issue a notice, by certified mail or in person, informing the taxpayer of the filing of a Notice of Federal Tax Lien "not more than 5 business days *after the day of the filing* of the notice of lien." (Italics added.) The notice also advises the taxpayer of his or her right to a CDP hearing during the 30-day period beginning on the day after the 5-day period described above.[52] As explained below, because of the delays encountered by the numerous local jurisdictions in filing (recording) the Federal tax lien, some taxpayers who file outside of the 30-day period running from the date of *mailing* the CDP notice will file timely hearings while others will not.

Except in exigent circumstances where an RO must take an NFTL directly to the recording office for filing, all NFTLs are generated using the Automated Lien System (ALS).[53] The Revenue Officer or ACS employee enters into ALS a request that an NFTL be filed.[54] ALS will then generate an NFTL.[55] A paper copy of the NFTL will be printed to be mailed to those recording offices without electronic submission capability.[56] An electronic copy of the NFTL will be transmitted to recording offices that accept electronic submission.[57] The date the NFTL is generated is shown in ALS. Because ALS employees are instructed to print no more NFTLs than can be mailed the same day as the printing, the date of printing is generally assumed to be the same date the NFTL is mailed for filing.[58] A certified mail log is maintained at each ALS facility to document the mailing of the NFTL.

Letter 3172, the CDP notice under IRC § 6320, is generated and printed on the day after the NFTL is generated by ALS.[59] Consequently, there should not be any difficulty figuring out the date the NFTL is sent (either electronically or by mail) to the recording office for fil-

[52] IRC § 6320(a)(2)(B).

[53] IRM 5.12.6.2.

[54] *Id.*

[55] *Id.*

[56] IRM 5.12.2.12.

[57] IRM 5.12.2.11.

[58] IRM 5.12.6.2.5.

[59] IRM 5.12.6.3.2.

ing. On the other hand, the IRS would have to make individualized determinations about when the NFTL is actually filed by the recording office. Thus, under current law, which counts the CDP reply date from the date of lien filing, one taxpayer may have 30 days within which to respond to the CDP Lien notice and another taxpayer may have 60 days, simply because of the vagaries of U.S. mail or the backlog of filing work in some recording offices. Further, one taxpayer responding in 60 days from mailing of the CDP Hearing Notice will be entitled to a CDP Hearing with judicial review, while another responding within the same timeframe can only obtain an equivalent hearing, without judicial review.

In order to eliminate this disparate treatment of taxpayers, the National Taxpayer Advocate recommends that IRC § 6320(a)(2) be amended to provide that the CDP Hearing Notice be mailed (by certified mail) or delivered not more than 5 business days after the day the notice of lien is mailed or otherwise submitted for filing. In addition, IRC § 6320(a)(2)(B) should be amended to provide that the 30-day period in which a taxpayer can request a CDP hearing should begin on the day after the date the notice is provided under IRC § 6320(a)(2). This language will account for the many NFTLs that are sent electronically, or those that are filed by hand in exigent circumstances.

Administrative Recommendations

CDP in the Context of Administrative Law

In 1946 Congress enacted the Administrative Procedure Act (APA),[60] which serves as the basis for most modern administrative procedure. The Act bifurcates administrative agency action into adjudication and rulemaking, and categorizes adjudicatory determinations, in turn, into formal and informal proceedings. While formal adjudications include the right to be heard before an Administrative Law Judge (ALJ) and formal trial-like safeguards, the APA provides little, if any, guidance about what constitutes an informal administrative practice.

IRS deficiency determinations are exempt from the APA's formal adjudication requirements because they are subject to a subsequent trial *de novo* in the Tax Court on issues of both law and fact.[61] CDP hearings, on the other hand, clearly share many of the characteristics of informal agency hearings under the APA, including judicial review under an abuse of discretion standard.[62]

Many Federal agency informal agency adjudications provide for face-to-face hearings, sworn testimony, limited discovery and recording or transcription of the proceedings.[63]

[60] 5 USC §§ 551 et.seq.

[61] Staff of Senate Judiciary Committee, 79th Cong., Administrative Procedure Act 23 (Comm. Print 1945) (Explanations of the provisions of the Adminstrative Procedure Act).

[62] *Davis v. Comm'r*, 115 T.C. 35 (2000) (CDP hearings are informal);

[63] *See* Defense Office of Hearings and Appeals, *Pre-hearing Guidance* and Department of Defense *Directive 5220.6* (allowing for face-to-face adversarial proceeding, cross examination of witnesses, testimony while not under oath is subject to 18 U.S.C.A. §1001 making perjury criminal offense, and hearing recorded by court reporter); *Board of Veterans' Appeals: Understanding the Appeal Process* and 38 C.F.R. § 20.700 *et seq.* (allowing for face-to-face or video conferencing, testimony under oath and audio recording of proceedings); Bid Protests at GAO: A Descriptive Guide and 4 C.F.R. § 21.01 *et seq*; (providing for face-to-face hearings, presentation of witnesses and audio recording of proceedings); *Federal EEO Complaint Processing Procedures* and 29 C.F.R. 1614.108 (providing for pre-hearing discovery, presentation of witnesses, audio recording of hearing and adjudication by administrative law judge).

In many informal administrative hearing processes, the petitioner receives notice of the hearing date together with an explanation of what will take place at the hearing. The agency involved often summarizes the rules of procedure in non-legal terms on the agency's Internet site or mails them to the petitioner as part of an information packet.[64] This information is especially important in administrative settings where the vast majority of petitioners are not represented by counsel, as is the case in CDP hearings.[65]

Face-to-Face Hearings

Treasury Regulations present conflicting information as to the nature of the CDP hearing. For example, one part of the regulations pertaining to CDP hearings suggests that the CDP hearing need not be conducted face-to-face but may be the exchange of correspondence.[66] In a subsequent provision, however, the regulations indicate the taxpayer will receive a face-to-face hearing upon request.[67] The Office of Appeals currently treats all CDP hearings presumptively as telephonic and is providing only 14 days for the taxpayer to respond and request a face-to-face session.[68] Moreover, the IRS has taken the position in a number of litigated cases that taxpayers are not guaranteed the right to a face-to-face hearing, even when such a hearing is requested.[69]

[64] *See, e.g.*, Department of Defense at http://www.defenselink.mil/dodgc/doha/isp-pg.html;Department of Veterans Affairs at http://va.gov/vbs/bva/y2000.pdf; http://va.gov./vbs/bva/010202A.pdf; the General Accounting Office at http://www.gao.gov/decisions/bidpro/bid/bidreg.html; and the Equal Employment Opportunities Commission at http://www.eeoc.gov/federal/fsp2001/part_v.html.

[65] In the 2003 Annual Report to Congress, TAS analysis of published opinions concluded that less than 13 percent of taxpayers were represented in CDP hearings. National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 322. For 2004, 75 percent of the litigants in CDP cases were *pro se*. *See t*his report, Most Litigated Issues, Collection Due Process, *infra.*

[66] Treasury Regulation § 301.6330-1(d), Q-D6 & A-D6 provides as follows:
A CDP hearing may, but is not required to, consist of a face-to-face meeting, one or more written or oral communications between an Appeals officer or employee and the taxpayer or the taxpayer's representative, or some combination thereof.

[67] Treasury Regulation § 301.6330-1(d)(2), Q-D7 & A-D7 provides as follows:
Q-D7. If a taxpayer wants a face-to-face CDP hearing where will it be held?
A-D7. The taxpayer must be offered an opportunity for a hearing at the Appeals office closest to taxpayer's residence or, in the case of business taxpayers, the taxpayer's principal place of business. If that is not satisfactory to the taxpayer, the Appeals officer or employee will review the taxpayer's request for a CDP hearing, the case file, any other written communications, if any, submitted in connection with the CDP hearing), and any notes of any oral communications with the taxpayer or the taxpayer's representative. Under such circumstances, review of those documents will constitute the CDP hearing for the purposes of section 6320(b).

[68] Appeals Letter 3855 (03/04).

[69] Courts have held that where the taxpayer has not unduly delayed the proceedings, the taxpayer is entitled to a face-to-face hearing. *Cavanaugh v. U.S.*, 93 A.F.T.R.2d 2004-1522, 2004 WL 880442, p. 6 (D. N.J. 2004). In *Cavanaugh*, the taxpayer requested a face-to-face hearing; however, the IRS took the position that the CDP hearing had taken place during a telephone conference with the taxpayer and that a face-to-face hearing was not required even where it was requested by the taxpayer. The United States District Court held that the Appeals officer abused her discretion in denying the face-to-face hearing, especially in light of the fact that the taxpayer claimed he did not even know that the telephonic hearing was (in the IRS's view) his CDP hearing. *See also Leineweber v. Comm'r*, T.C. Memo 2004-17 (holding that Appeals officer did not abuse discretion when officer had several times attempted to schedule the taxpayer's requested face-to-face hearing, but taxpayer would not agree to any of the suggested dates or offer any alternative dates); *Mann v. Comm'r*, T.C. Memo. 2002-48 (holding that taxpayer failed to attend scheduled hearing and therefore, waived right to complain about not receiving a face-to-face hearing).

In furtherance of this shift away from face-to-face hearings, Appeals is beginning to send some CDP case files to the IRS campuses (formerly known as service centers). This practice will result in the files of taxpayers being sent to campuses which are not geographically proximate to the taxpayers. Although it is the understanding of the National Taxpayer Advocate that these cases will be returned to the appropriate local Appeals office if the taxpayer requests a face-to-face hearing (and if the taxpayer otherwise qualifies for such a hearing pursuant to IRM 8.6.1.2.5), this policy will inevitably result in delay when cases are sent back to the local Appeals office and may result in taxpayers being dissuaded from exercising their right to a face-to-face hearing.

This policy will also disparately impact low and middle income taxpayers who are generally unrepresented and who may benefit the most from a face-to-face hearing in presenting their cases.[70] Moreover, if a taxpayer intends to address any substantive issue about his or her liability, it is clearly advantageous to have a face-to-face hearing to allow for an exchange of documents or the presentation of witnesses. As the Appeals' Customer Service Surveys indicate, taxpayers often prefer face-to-face contact.[71]

Of course, it is entirely possible for taxpayers to find a telephonic or correspondence hearing preferable to a face-to-face hearing. For example, where the taxpayer is only questioning whether all requirements of law and administrative procedures have been met, a face-to-face hearing may not be necessary. Further, where the taxpayer is raising only those issues that have been deemed groundless by the courts and Congress, and is not raising "verification" issues or collection alternatives, Appeals would be justified in limiting access to face-to-face hearings.[72] Absent these concerns, however, Appeals should provide taxpayers with the option to select the type of hearing they want and allow adequate time for them to make that request.

The Administrative Hearing Record

Creating a record of what has transpired at an administrative hearing is an important part of the administrative process. A written transcript or audio recording of a hearing provides a court with a complete record of the administrative hearing so that it may review the propriety of government action.[73] For this reason, administrative procedures often mandate that a record be made, either by transcript or audio recording, so that the review-

[70] *Supra*, Note 5.

[71] The surveys include typical comments from taxpayers about their desire for face-to-face contact, including: *"Provide face-to-face meetings with Appeals officers;" "It's important to actually meet the officers to explain my situation;" and "Appeals officers should take the time to meet with the taxpayer. They would find out a whole lot more than just what was on paper."* Internal Revenue Service, *Appeals Customer Satisfaction Survey*, January 2004, 7.

[72] The National Taxpayer Advocate generally supports this legislation. However, she is concerned that the language as presently drafted may be read to deny CDP hearings to those taxpayers who are legitimately seeking to delay collection in order to challenge the underlying liability or to present collection alternatives. 5.882.

[73] *Keene v. Comm'r*, 121 T.C. 8, 17-18 (2003).

ing court has an adequate basis for its decision. This is especially true where the court is employing an abuse of discretion standard, whereby the court confines its inquiry to matters contained within the record.[74] An audio or written record of the proceedings is especially important for CDP hearings since the taxpayer may only seek judicial review of Appeals' determination on those issues that were raised at the hearing.[75]

Treasury Regulations provide that "[a] transcript or recording of any face-to-face meeting or conversation between an Appeals officer or employee and the taxpayer or the taxpayer's representative is not required."[76] Relying on these regulations, courts have held that Appeals officers are not required to allow taxpayers to record CDP hearings, particularly where the taxpayer is raising frivolous arguments.[77] In *Keene v. Commissioner*, however, the United States Tax Court held that IRC § 7521 requires the Appeals officers to permit recordings if the taxpayer requests them and provides resources for a tape recording.[78] Notably, the Tax Court held in *Keene* that "not having a transcript may contravene the intent of Congress in providing for a fair and impartial administrative hearing and may have a negative impact on this Court's review of the Appeals Office determination."[79]

Similarly, a concurring opinion in *Keene* noted:

> Having a transcript of the section 6330 hearing will allow us to perform better review provided to taxpayers by section 6330(d). Until now, in order to determine what issues taxpayers raised at the section 6330 hearing, the Court was faced with "he said-she said" situations – needless "credibility contests" between the taxpayer

[74] *Keene v. Comm'r* 121 TC 8, 17-18 (2003). But see *Robinette v. Comm'r*, 123 T.C. 85 (2004) (holding Tax Court could properly consider evidence not in the administrative record that taxpayer attempted to introduce at CDP hearing).

[75] Treasury Regulations §§ 301.6330-1(f)(2) provide:
Q-F5. What issue or issues may the taxpayer raise before the Tax Court or before a district court if the taxpayer disagrees with the Notice of Determination?
A-F5. In seeking Tax Court or district court review of Appeals' Notice of Determination, the taxpayer can only ask the court to consider an issue that was raised in the taxpayer's CDP hearing.

[76] Treas. Reg. §301.6320-1(d) A-D6 and Q-D6.

[77] *Horton v. Comm'r*, T.C. Memo. 2003-197 (holding that it would not be productive to remand case so that taxpayer could record hearing where taxpayer makes frivolous arguments); *Ray v. United States of America*, 291 F.Supp.2d 1179, 1181 (D. Nev. 2003) (holding there was no right under the CDP statutes or IRC § 7521 to record CDP hearing where Appeals did not permit taxpayer to record CDP hearing,); *Jewett v. Comm'r*, 292 F.Supp2d 962, 966 (N.D. OH 2003) (holding Treasury Regulations did not require Appeals to allow taxpayer to record CDP hearing); *Synder v. Comm'r*, 93 A.F.T.R.2d 2004-425 (N.D. OH 2003) (holding taxpayer does not have right to record CDP hearing where taxpayer's arguments were frivolous); *Kemper v. Comm'r*, T.C. Memo. 2003-195 (holding that taxpayer does not have right to record CDP hearing where taxpayer's arguments were frivolous); *Brashear v. Comm'r*, T.C. Memo. 2003-196 (holding taxpayer does not have right to record CDP hearing where claims were frivolous); *Yuen v. United States of America*, 290 F.Supp.2d 1220 (D. NV 2003) (holding CDP hearings are informal and taxpayer has no right to record CDP hearing where taxpayer is advancing arguments that are frivolous); *Muhammad v. United States of America*, 91 A.F.T.R.2d 2003-1985 (D. SC 2003)(holding that while it may not have been an abuse of discretion to deny taxpayer the ability to record hearing there was an insufficient record for court to find for IRS as a matter of law); *Norsworthy v. Killfoil*, 93 A.F.T.R.2d 2004-1700 (holding that taxpayer has no right to record CDP hearing).

[78] *Keene v. Comm'r*, 121 T.C. 8, 17 (2003).

[79] *Id*.

> and the Appeals officer. In many cases, this contest was not fully developed because the only evidence submitted to determine what issues were raised at the hearing was the notice of determination.[80]

While Appeals has changed its procedures in response to *Keene*, it allows only face-to-face hearings to be recorded, and then only upon the taxpayer's specific request.[81] Most taxpayers do not have the sophistication to appreciate the importance of recording the hearing, and a rational taxpayer may instinctively trust the hearing officer to look out for his or her procedural interests. Notwithstanding that the United States Tax Court noted in *Keene* that the lack of a record hinders its review of CDP hearings, Appeals does not presumptively establish hearings as subject to recording and does not even notify taxpayers of this important right. The Office of Appeals should clearly inform taxpayers that, where they are entitled to a face-to-face hearing, they have the right to record such hearing at their expense.

Notice as to the Nature of the CDP Hearing

Internal Revenue Code sections 6320 and 6330 require the IRS to send to a taxpayer subject to a lien filing or a levy a notice that describes "the procedures related to such appeals" in simple and non-technical terms.[82] When the appropriate compliance function sends the taxpayer the Notice of Filing of Tax Lien and the Notice of Intent to Levy, the taxpayer is sent Publication 1660, Collection Appeal Rights, which addresses the general manner for obtaining an appeal. While the taxpayer may be sent Publication 1660 by the compliance officers working the collection case, this document provides no information about the CDP hearing (although it does describe how to obtain a hearing).[83] Publication 1660 does not answer such basic questions as:

- What will occur at the hearing?
- Will the CDP hearing be in a courtroom setting?
- How does the hearing process work and what are the rules?
- Is the hearing recorded?
- How can I learn about collection alternatives?

Upon receipt of the CDP case in the Office of Appeals, Appeals sends to the taxpayer an acknowledgement letter (Letter 13221) along with Publication 4165, An Introduction to Collection Due Process Hearings. Publication 4165 is a one-page document divided into four sections: Mission, Expectations, Overview of Appeals Process, and Collection Due Process.[84] This document references some important concepts such as "innocent spouse"

[80] *Keene v. Comm'r*, 121 TC 8, 17-18 (2003) at 24.

[81] IRM 8.6.1.2.5 (5-13-04).

[82] IRC §§ 6320(a)(3)(C) and 6330(a)(3)(C)(iii).

[83] IRS Compliance sends Publication 1660, *Collection Appeals Rights*, after a lien or prior to a levy. This publication provides general information on how to obtain a CDP hearing but does not explain the CDP hearing process.

[84] Internal Revenue Service, *An Introduction to Collection Due Process Hearings*, Publication 4165 (Rev. 09-2003).

relief and "collection alternatives" but does not give the taxpayer the information that would make these concepts useful. The Appeals' Customer Satisfaction Survey indicates that taxpayers want this information early in the process.[85] Yet this document is sent as late as 120 days after the taxpayer files his or her CDP request, since Appeals does not acknowledge the CDP request until it actually receives the case from Collection.

When the case is actually assigned to a Hearing Officer's inventory, a "substantive contact" letter is sent, Letter 3855.[86] This letter recites in general what matters can be raised at the hearing, such as an offer in compromise, installment agreement or innocent spouse, and requests certain information from the taxpayer, including financial statements, tax returns, and proof of estimated tax payments, as appropriate. It also advises the taxpayer that the requested information must be provided within 14 days of the date of the letter.

Notice about Collection Alternatives

As noted above, the CDP hearing process provides the taxpayer with an opportunity to present collection alternatives, such as offers-in-compromise, installment agreements, lien subordination, or partial discharge of property from the effect of the lien. However, taxpayers currently do not receive a clear and concise explanation of all available collection alternatives. Consequently, taxpayers present incomplete or unrealistic collection alternatives, which result in further delays or unsatisfactory outcomes.[87]

An example of effective pre-hearing communications can be found in the Board of Veterans' Appeals 44-page publication *Understanding the Appeals Process*. Although we do not suggest that Appeals needs to produce a document of this length, this publication provides a large quantity of information in a readable format and takes the hearing participant through each step of the process and containing very helpful topics, including

- *What is the Board of Veterans' Appeals?*
- *What is an Appeal to the Board of Veterans' Appeals?*
- *What can I appeal?*
- *When will my personal hearing be held?*

[85] The Customer Satisfaction Survey contains typical quotes from taxpayers regarding the way Appeals communicates with taxpayers, including: "*My options were not clearly explained;*" "*I would like the Appeals officer to tell me exactly what he expects from me;*" "*At the end of the process, the officer should communicate the payment options and when they would start;*" and "*Provide better information to the taxpayer regarding which guidelines apply and what resources are available.*" Pacific Consulting Group, IRS Customer Satisfaction Survey, Appeals National Report

[86] Appeals is currently considering combining the acknowledgement and substantive contact letter where the manager can determine from the administrative file what taxpayer information is required before assignment to a Hearing Officer.

[87] Appeals has previously taken the position that Publication 3498 (*The Examination Process*) provides all the necessary information about the main collection alternatives. National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 53. Even if Publication 3498 offered useful information, this publication is not sent out to taxpayers in the CDP hearing process, but to those disputing results from an IRS-initiated examinations.

- *How long does the appeal process take?*
- *Do I need a lawyer or other representative to help me with my appeal?*

A particularly helpful section is *"What should I avoid?"* which informs petitioners of the common mistakes that other petitioners make. CDP hearing participants would greatly benefit from more information about the CDP hearing process. Since it will benefit both Appeals and taxpayers if taxpayers know more about the CDP hearing process, the Board of Appeals' *Understanding the Appeals Process* would be an excellent model.

Another example of helpful procedures is closer to home in the tax world. The United States Tax Court provides on its website and mails on request a clear and informative booklet about Tax Court procedures as well as a sample, fill-in petition. This is appropriate for a court in which 83 percent of its petitioners are *pro se*.[88] The court later sends to the taxpayer a Pretrial Memorandum form and the presiding judge's specific instruction for courtroom demeanor and procedures, in order to ensure that petitioners present all relevant information as well as maintain orderly court proceedings, to provide notice to opposing counsel of issues and witnesses, and to develop a record. The layout of the Pretrial Memorandum walks the taxpayer through identifying legal and factual issues in dispute, witnesses to be called, and relevant case law.

The Office of Appeals should adapt this approach to CDP hearings. It should model its Publication 4165, *An Introduction to Collection Due Process Hearings*, after the Tax Court's publication, *Election of Small Tax Case Procedure and Preparation of Petitions*, and the Board of Veterans' Appeals publication, *Understanding the Appeals Process*. This revised publication should be sent to the taxpayer immediately upon receipt of the CDP hearing request. The publication could explain that the taxpayer has the opportunity to continue working with the Collection function for a period. But all collection alternatives would be fully described, with examples, along with detailed information about the CDP hearing process. The publication could include a "CDP Hearing Memorandum," modeled after the Tax Court's Pretrial Memorandum. This early notification will enable a taxpayer to really think about collection alternatives and develop the necessary documentation. If, by the time the case is assigned to a Hearing Officer, the taxpayer has not submitted a CDP Hearing Memorandum, the Hearing Officer should send the taxpayer another CDP Hearing Memorandum form with the substantive contact letter.

This approach helps to ensure that taxpayers understand the process and have the opportunity to raise relevant issues. It also helps to develop a more complete record of issues to be raised at the hearing and aids the courts in giving appropriate review to the agency's action in the case. The IRS' current failure to provide taxpayers with a clear and helpful explanation of the hearing process and develop forms that enable the taxpayer to both understand and raise all collection alternatives available to them, diminishes taxpayer protections and undermines the meaningfulness of the hearing process. Without complete information, Appeals cannot properly complete its required balancing of the government's and the taxpayer's interests. It cannot develop a record upon which a court can determine whether an abuse of discretion has occurred. In short, the IRS' current approach to CDP hearings reflects an inventory-driven system rather than a due process-driven approach. Thus, the IRS' approach fails to satisfy the intent of IRC §§ 6320 and 6330 to provide taxpayers with an opportunity for *meaningful* reviews of collection alternatives.

[88] Counsel Automated Tracking System, TL-708A, (FY 2003).

7 FREE ELECTRONIC FILING FOR ALL TAXPAYERS

PROBLEM

More than 50 million individual taxpayers prepare their own returns.[1] Those who prepare and submit their returns on paper generally do not incur any fees. By contrast, taxpayers who file electronically often must purchase software and pay a filing fee to a private vendor. In light of the clear benefits of e-filing to both taxpayers and the IRS – and a Congressional directive that the IRS work toward a goal of having 80 percent of all returns filed electronically by 2007[2] – there is no logic to imposing additional costs on taxpayers to prepare and submit their returns electronically.

EXAMPLE

A taxpayer with a wife and two children earns $45,000 a year. He has a simple return and is able to complete it without professional assistance. The taxpayer receives a booklet from the IRS containing paper tax forms. From past experience, he knows and expects that he can file his return without incurring any fees. The taxpayer looks into preparing and filing his return electronically. To his surprise, he discovers that he must pay two fees to a private vendor – one to purchase software to prepare his return and another to file the return electronically.[3] To avoid these costs, the taxpayer decides to file on paper.

RECOMMENDATION

Revise Internal Revenue Code § 6011(f) to provide that the Secretary shall make electronic return preparation and electronic filing available without charge to all individual taxpayers.

Alternatively, Congress could direct the Secretary to conduct a study, in conjunction with the Office of the Taxpayer Advocate, to evaluate the feasibility of providing taxpayers with both a template for use in preparing their returns and a direct filing portal for use in filing returns. The study should result in a report describing options considered and conclusions reached, and should be submitted to the House Ways and Means and Senate Finance committees within two years.

PRESENT LAW

Paper Filing

Internal Revenue Code § 6011(a) provides that any person made liable for tax, or with respect to the collection of tax, shall make a return or statement according to the forms and regulations prescribed by the Secretary. Treas. Reg. § 1.6011-1 provides that "[c]opies of the prescribed return forms will so far as possible be furnished to taxpayers" by the IRS.

[1] Tax Year 2002, IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF).

[2] Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, § 2001(a)(2), 112 Stat. 685 (1998).

[3] Some vendors offer a rebate that covers the cost of the filing fee. However, taxpayers generally must take additional steps to receive the rebate, including completing and mailing a form and submitting documentation.

Consistent with this regulation, the IRS makes copies of its paper forms available to taxpayers without charge.

Electronic Filing

Internal Revenue Code § 6011(f) provides that the Secretary is authorized to promote the benefits of and encourage the use of electronic tax administration programs, as they become available, through the use of mass communications and other means.

To date, the IRS has decided against making e-filing available to all taxpayers without charge. Instead, the IRS entered into a three-year agreement prior to the 2003 filing season with a consortium of tax preparation software companies (collectively known as the Free File Alliance). The Free File Alliance agreed that its member companies would, in the aggregate, make free electronic preparation and filing available to at least 60 percent of all individual taxpayers. In return, the IRS pledged that it would "not compete with the [Free File Alliance] in providing free, on-line tax return preparation and filing services to taxpayers."[4] As a consequence of this agreement, up to 40 percent of individual taxpayers may be required to pay fees to prepare and file their returns electronically.[5] The existing agreement will expire in 2005. However, the IRS intends to continue its arrangement with the Free File Alliance and expects to conclude a new agreement with the Alliance before the end of April 2005.[6]

REASONS FOR CHANGE

The Affirmative Case for IRS Provision of a Basic Free E-filing Option

The IRS should make it possible for all taxpayers to prepare and file their returns electronically without incurring fees. As the Senate Finance Committee noted, e-filing benefits both taxpayers and the IRS.[7] From a taxpayer perspective, e-filing eliminates the risk of IRS transcription errors, pre-screens returns to ensure that certain common errors are fixed before returns are accepted, and speeds the delivery of refunds. From an IRS perspective, e-filing eliminates the need for data transcribers to input return data manually (which could allow the IRS to shift resources to other high priority areas), allows the IRS to easily capture return data electronically, and enables the IRS to process and review returns more quickly.[8]

---

[4] Agreement between the Internal Revenue Service and the Free File Alliance, LLC, titled "Free On-Line Electronic Tax Filing Agreement," Parts II & III (dated as of Oct. 30, 2002).

[5] Our understanding is that each member of the Free File Alliance generally may set its own eligibility criteria. At least one member company has made free e-filing available to most taxpayers in the last two years, presumably viewing it as a marketing opportunity to showcase other products. As a result, the number of taxpayers who were able to prepare and file their returns electronically in those years substantially exceeded 60 percent. However, it is also our understanding that other members of the Free File Alliance expressed extreme dissatisfaction with the higher coverage rate, presumably out of concern that providing free electronic return preparation and filing to too many taxpayers could reduce the market for for-fee products. It should be emphasized that any coverage level in excess of 60 percent in a given year is purely discretionary on the part of the member companies.

[6] *See* Most Serious Problem, Electronic Return Preparation and Filing (IRS Comments), *supra.*

[7] *See* S. Rep. No. 105-174, at 39-40 (1998).

[8] The 80 percent e-filing goal set forth in the IRS Restructuring and Reform Act of 1998 may be unrealistic. However, we believe Congress should reiterate its commitment to seeing the IRS increase the e-filing rate as quickly as possible.

There are multiple reasons why the government should give all taxpayers the opportunity to e-file their returns directly to the IRS without charge. First, it is the right thing for the government to do. Taxes are the lifeblood of government, and the government asks people to "voluntarily" come forward and pay taxes to support its many programs and services. Considering that the government is requiring people to pay over a substantial percentage of their incomes every year, requiring people to complete sometimes extensive forms detailing their financial dealings every year, and expressing a strong preference that people stop using paper forms and start preparing and filing their returns electronically, it is unfair bordering on offensive to expect people to pay additional transaction costs simply to do what the government asks. To say the least, such a policy does not further the IRS's stated #1 goal of improving "taxpayer service."[9]

Second, there is substantial research showing that taxpayers view cost as a significant barrier to e-filing.[10] A study conducted for the IRS in 2003 found that 11 percent of paper-return filers avoid e-filing because of cost, as illustrated in our Example above.[11] A separate IRS study, conducted for the Wage and Investment Operating Division, surveyed taxpayers who prepared returns electronically but mailed them to the IRS on paper. In explaining why they chose not to file electronically, 51 percent of these taxpayers reported that cost was a "strong" factor, and another 22 percent reported that cost played some role in their decision.[12]

Third, the results from focus groups conducted for the IRS by an independent research firm suggest that many taxpayers are leery of dealing with third parties and would prefer to file directly with the IRS. As part of the focus groups, participants in four cities were given a description of Free File. The research report noted that, in all four cities, "people

[9] *IRS Strategic Plan 2005-2009*, at 12.

[10] It would also be appropriate to examine the costs imposed on tax practitioners to e-file returns. In 2003, more than 31 million individual returns were prepared by practitioners electronically yet submitted on paper. Tax Year 2002, IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF). According to IRS filing data, more than two-thirds of all practitioners who signed returns prepared fewer than 10 returns overall. *Id.* For these practitioners, the costs of becoming or using an electronic return originator (ERO) may be excessive. If the submission of returns electronically were cost-free, many more returns undoubtedly would be e-filed. One option to consider is whether it is feasible to strengthen the due diligence requirements under Circular 230 so that covered practitioners can qualify for e-filing without separately complying with the ERO requirements. We have not examined this approach and are not now endorsing it, but we are suggesting that something along these lines might make e-filing more attractive for practitioners and thus reduce substantially the number of returns prepared electronically by practitioners yet submitted on paper.

[11] Russell Marketing Research, Findings From The 2003 Wave Of *e-file* Taxpayer & Preparer Satisfaction Research, Presentation at the 2003 IRS Research Integration Meetings, screen 37 (July 2003).

[12] "Survey of Taxpayers Who Self-Prepared and Filed a V-Coded Return," ETA Research Project 1-02-08-3-005, W&I Division, Customer Research Group 1, 10 (Jan. 13, 2003). In 2003, the IRS received more than 43 million returns that had been prepared electronically yet submitted on paper; of that total, about 31 million had been prepared by practitioners and about 12 million had been self-prepared. Tax Year 2002, IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF).

were guarded about [Free File] at first, and then surprisingly, as we discussed it, they really grew quite skeptical of it."[13] Among the comments were the following:

> "Any time that you use a middleman, especially on the Internet, I just have a lot of red flags about that, just because you don't know where it's going to go."[14]
>
> "If it was free and it was an IRS tax program, then it probably wouldn't bother me and I wouldn't hesitate. But because it's an external company, I do."[15]
>
> "I have a little squeamishness related to third parties. I would have less of a problem, I guess with the IRS, if it was an actual IRS site where you were submitting it electronically."[16]
>
> "I just get skeptical when one site leads to another site that's supposed to be secure. If it were under the IRS.gov website address and it was just a separate page there, I would feel better about it."[17]
>
> "When I went to the website, it wasn't even the IRS who was offering the electronic filing service. There were several different companies. So that was another thing that concerned me. Even though I had been sent there by the IRS, I'd never heard of these companies. I wasn't so much worried about security over the Internet, I was worried about who were these people who are filing my tax returns?"[18]

While the reactions of these focus group participants cannot accurately be projected to the entire tax-filing population, their comments are revealing and suggest there is a substantial segment of the tax-filing population that would be far more likely to file their returns electronically if they could do so directly to the IRS.[19] Indeed, the IRS Oversight Board recently recommended that the IRS "consider the benefits and costs of implementing a direct filing portal through which the IRS can receive tax returns prepared by commercial tax software without the use of a third party to transmit the information."

[13] Russell Marketing Research, Findings From Focus Groups Among Taxpayers With Self-Simple Returns, screen 21 (March 2003). This study focused on taxpayers who prepare their own returns and file a simple return (defined as a Form 1040-series return with no additional schedules). This segment accounts for about 25 percent of all returns filed.

[14] *Id.*

[15] *Id.* at screen 22.

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] As a separate matter, we believe that some degree of taxpayer mistrust of commercial software companies may result from the cross-marketing pitches to which taxpayers are subjected. Many tax preparation software packages are written to advertise an array of products. Section 7216 of the Code generally prohibits tax return preparers, including software vendors, from disclosing or using a taxpayer's tax return information without consent. Some software vendors have built code into their software that targets marketing pitches to taxpayers based on personal tax information they enter in the course of preparing their returns without adequately explaining the taxpayer's legal right to withhold consent. As the IRS correctly points out in its response to our discussion of e-filing problems, taxpayer consent must be "informed" to be valid.

Fourth, the fact that all taxpayers may now file paper returns without charge but many must pay a fee to file their returns electronically provides precisely the opposite incentive one would expect if the IRS is serious about increasing the percentage of electronically filed returns to 80 percent. The IRS should be trying to make e-filing **less** expensive -- not **more** expensive.

Fifth, the argument for continuing the Free File arrangement would be stronger if the program had substantially increased the number of taxpayers who e-file their returns. But it has not. Out of 128 million returns filed for tax year 2003, 3.5 million came in through Free File.[21] That is less than three percent of individual returns. Moreover, even that number overstates the success of Free File because some, perhaps most, of those taxpayers were already filing electronically before Free File existed.[22]

A Response to Concerns About Interference With Private Industry

The IRS is devoting substantial resources toward increasing the percentage of e-filed returns, and we applaud the IRS for the emphasis it is placing on this objective. However, we are concerned that the IRS is attempting to achieve its goal by pursuing an inappropriately close relationship with the private tax preparation software industry, prompting it to refrain from providing a free e-filing option to all taxpayers. While it is certainly desirable that the IRS develop and maintain a positive working relationship with industry, the private sector and the IRS have very different objectives. The ultimate goal of a business is, quite properly, to maximize profits and shareholder value. The goal of the IRS should be to do what is best for taxpayers and the tax system. In this context, we believe that goal is best served by providing all taxpayers with an opportunity to e-file their returns easily, securely, and without cost.

The software industry, and to some extent the IRS, opposes placing a basic, fill-in template on the IRS website on the ground that it would improperly place the IRS in the position of competing with private industry. In our view, this argument lacks merit.

Since the inception of the tax system, there have always been two types of taxpayers – those who are comfortable enough with the rules to self-prepare their returns and those who turn to paid professionals for assistance. In the paper-filing world, the IRS has always made its forms and instructions universally available without charge to all taxpay-

[20] IRS Oversight Board, *Electronic Filing Annual Report to Congress*, at 12 (Nov. 2003).

[21] General Accounting Office, *IRS Improved Performance in the 2004 Filing Season, But Better Data on the Quality of Some Services Are Needed*, GAO-05-67, 11 (Nov. 2004) (citing data through Sept. 17, 2004).

[22] The IRS does not have sufficient information to determine how many taxpayers using Free File had previously filed their returns electronically. The IRS has considered requiring companies participating in the Free File Alliance to include an electronic tag on all returns coming through Free File that would enable the IRS to determine how many returns came from first-time e-filers and how many returns came from repeat e-filers. The National Taxpayer Advocate believes this would be useful information. However, Free File members opposed the inclusion an electronic Free File tag and the IRS ultimately decided not to require it. We address this issue briefly. *See* Most Serious Problem, Electronic Return Preparation and Filing, *supra*.

ers, and those taxpayers who require help have always been free to seek the assistance of paid preparers. Imagine that, shortly after the income tax was enacted, a large group of bricks-and-mortar tax preparers had launched a lobbying campaign to try to persuade Congress to prohibit the IRS from making forms and instructions available to the public on the ground that the availability of these materials improperly placed the government in the position of competing with private industry. Surely, these preparers might have argued, the availability of free blank forms reduced the need for their services. Congress almost certainly would have rejected such an argument as ludicrous. Yet that is exactly the same conceptual argument being raised today by those who contend that the government's provision of a basic fill-in form to all taxpayers would undercut the private sector.

The answer to these arguments today should be the same answer that Congress would have provided 80 years ago. For those taxpayers who are comfortable preparing their returns without assistance, the government will provide the means to do so without charge. For those taxpayers who do not find a basic template sufficient and would prefer to avail themselves of the additional benefits of a sophisticated software program, they are free to purchase one.

Opponents of IRS's provision of a template frequently cite language in the IRS Restructuring and Reform Act of 1998 (RRA 98) conference report which states that the conferees want the IRS and Treasury "to press for robust private sector competition"[23] as well as a press release issued by the Treasury Department which states that the IRS should not "get into the software business."[24] However, neither Congress nor the Treasury Department has ever opposed the provision of free e-filing options to all taxpayers.

To the contrary, the RRA 98 conference report states that "the conferees also intend that the IRS should continue to offer and improve its Telefile program and make available a comparable program on the Internet,"[25] and former Treasury Secretary Paul O'Neill, in the very same press release often cited by Free File proponents, stated that "we need to reduce the burden on taxpayers in the short term by rapidly expanding opportunities such as e-filing, and making it free to those who choose it. *No one should be forced to pay extra just to file his or her tax return.*"[26]

[23] H.R. Conf. Rep. No. 105-599, at 235 (1998).

[24] Press Release, U.S. Department of the Treasury, Treasury, "IRS Announce New Efforts to Expand E-Filing," Treas. PO-964 (Jan. 30, 2002) (emphasis added).

[25] H.R. Conf. Rep. No. 105-599, at 235 (1998). Telefile is a program akin to a basic template that allows taxpayers to file certain returns by telephone without charge. The IRS plans to eliminate Telefile in 2006.

[26] Press Release, U.S. Department of the Treasury, Treasury, "IRS Announce New Efforts to Expand E-Filing," Treas. PO-964 (Jan. 30, 2002) (emphasis added).

EXPLANATION OF RECOMMENDATION

The electronic preparation and filing of a return are two distinct actions.

Return Preparation. To make free electronic preparation available to all taxpayers, the IRS should place a basic template consisting of fill-in forms on its website. The template should allow taxpayers to enter data (*e.g.*, enter total wages on line 7 of Form 1040), should tabulate basic entries, and should link to form instructions and IRS publications, but it would not otherwise be interactive. Several private companies already have developed basic templates, so the IRS could select an outside vendor to provide and maintain its template.

Return Filing. To make free electronic filing available to all taxpayers, the IRS should develop a direct filing portal. The portal should allow all taxpayers who prepare their returns using a software program that meets approved IRS technical specifications (currently, XML standard), including the template that we recommend be developed, to file electronically without charge. A direct filing portal would present certain security challenges. However, the Federation of Tax Administrators reports that nearly half of all states already have created and implemented direct filing portals to enable taxpayers to file their returns directly, so it is clearly a manageable task.[27] The IRS thus can study and learn from the experiences of the states and then modify those procedures as it sees fit.

As currently written, we believe that Internal Revenue Code § 6011(f) provides the IRS with sufficient authority to post a template and make electronic filing available without charge to all taxpayers. However, the IRS has not exercised this authority, partly because of its desire to avoid incurring costs and partly because the software industry has vigorously, if selectively, cited the language in the RRA 98 conference report regarding "robust private sector competition" to suggest that the IRS lacks the authority to provide free e-filing services. Amending IRC § 6011(f) to provide that free e-filing should be made available to all individual taxpayers would clear up any confusion.

In response to our discussion of e-filing problems, the IRS stated that it plans to act early in 2005 to renew the Free File agreement.[28] The new agreement presumably will again contain a provision prohibiting the IRS from providing free electronic return preparation and filing options to taxpayers. For that reason, we encourage quick action on this recommendation.

[27] Federation of Tax Administrators, *FTA Bulletin: Electronic Income Tax Filing Grows in Importance at the State Level*, Ref. No. B-28/04 (Dec. 1, 2004).

[28] *See* Most Serious Problem, Electronic Return Preparation and Filing, *supra*.

RECOMMENDATIONS

LEGISLATIVE RECOMMENDATIONS

8 TAX GAP RECOMMENDATIONS

PROBLEM

The IRS estimates that the annual gross tax gap (i.e., the amount of tax that is imposed by law for a given year but is not paid voluntarily) is about $311 billion, and the annual net tax gap (*i.e.*, the gross tax gap reduced by taxes eventually collected) is about $255 billion.[1] The $255 billion net tax gap results in an average annual "surtax" of nearly $2,000 on each taxpayer. While increased IRS compliance activities can help to reduce this burden, such activities themselves have the potential to impair taxpayer rights and impose additional burdens on taxpayers.

At a hearing on the tax gap before the Senate Finance Committee in July 2004, the IRS Commissioner agreed, at ranking minority member Senator Max Baucus' request, that he would present the Committee with three alternative plans for reducing the tax gap attributable to the cash economy – the most stringent, the most lenient, and the moderate – by March 31, 2005.[2] In this report, the National Taxpayer Advocate presents a wide-ranging list of options for closing this and other portions of the tax gap. As noted above, while each possible approach has certain compliance benefits, each would also impose various levels of burden on taxpayers. By presenting this list and identifying the burdens as well as benefits, we hope that we will be of assistance to both Congress and the IRS as they work together to solve the challenging problems posed by the tax gap.[3]

Addressing the Tax Gap: The Role of the Office of the Taxpayer Advocate

The National Taxpayer Advocate's contribution to the discussion about the tax gap should focus on the impact it has on taxpayers in the aggregate and on taxpayers individually.

The Tax Gap and the Rights of Taxpayers as a Group

The mere fact that honest taxpayers are paying so much extra in taxes due to noncompliance constitutes an extraordinary abridgement of taxpayer rights and raises fundamental issues of fairness. Millions of wage-earning taxpayers, who are subject to income and payroll tax withholding, pay their taxes regularly and dutifully.[4] Moreover, millions of small business and self-employed taxpayers scrimp and save in order to pay their required quarterly estimated tax payments. Yet, because some taxpayers fail to report their income and are

[1] Supra p 5 at note 16.

[2] Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 TNT 145-30, (Release Date: July 8, 2004) (Doc 2004-15394), (Q&A of Commissioner Mark W. Everson), 56.

[3] Because we intend this particular Key Legislative Recommendation to be a comprehensive list of possible proposals, some items on the list would require Congressional action and some would require administrative action.

[4] Where taxpayers are subject to a withholding at source requirement, their compliance rate is 99 percent. *See* Alan Plumley and C. Eugene Steuerle, "An Historical Look at the Mission of the IRS: What is the Balance between Revenue and Service," 4.

not subject to third party reporting or withholding, compliant taxpayers must foot the bill for others' noncompliance and, if they are small businesses, are placed at a competitive disadvantage. The National Taxpayer Advocate's role with respect to the tax gap and the rights of taxpayers as a whole, then, is to ensure that the IRS develops initiatives that address components of the tax gap that place a disproportionate tax burden on compliant taxpayers.

The Tax Gap and the Rights of Taxpayers as Individuals

Any new or enhanced enforcement initiative has the potential itself to abridge taxpayer rights. As we have discussed throughout this report, the IRS' enforcement initiatives impact not only those taxpayers who are noncompliant but also those who are compliant and who are trying to comply. For example, we may all agree that more third party reporting of income will have a positive impact on the compliance rate. Reasonable people can disagree, however, about the details of such a proposal. Which taxpayers should be subject to third party reporting? At what dollar threshold should third party reporting apply? Should third party reporting be expanded to cover services provided to individuals as well as businesses? Should third party reporting extend to goods as well as services provided? Each one of these proposals imposes a burden on the taxpayer that may be required to report the income as well as on the taxpayer earning the income.

Moreover, our analysis cannot just stop at the level of burden. We must look at each proposal from the perspective of taxpayer rights. For example, the IRS could easily increase the amount of dollars it assesses by seeking legislative authority to use IRC § 6213(b) math and clerical error procedures for any mismatch between income reported by third parties and that reported on the taxpayer's return. But such an approach would both undermine the deficiency process which is fundamental to our tax system (including the ability to go to Tax Court before paying a proposed tax assessment) and unfairly impact those taxpayers who, for whatever reason, cannot navigate the tax system well by themselves or obtain representation to help them. It would also result in lots of work for the IRS and taxpayers further along in the tax controversy process – in Collection Due Process hearings, in audit reconsideration, in the Taxpayer Advocate Service.

The National Taxpayer Advocate, then, must look at tax gap proposals from the perspective of affected taxpayers, to determine whether and what taxpayer rights are impacted. Among these rights are the following:

- The IRS must provide a fair and equitable justification for the disparate treatment of one group of taxpayers from another.
- The IRS must research and articulate the reasons for noncompliance and design an initiative that takes into account the characteristics of the targeted taxpayer population.

- The IRS must identify specific barriers to compliance, including the barriers that the IRS itself creates (such as extensive documentation requirements, inadequate access to face-to-face or other assistance) and address elimination or reduction of those barriers as part of the compliance initiative.
- The IRS must protect the confidentiality of taxpayer and tax return information under IRC § 6103, which is the bedrock of taxpayer confidence in our tax system.
- The IRS must ensure that taxpayers have the opportunity to request an administrative appeal of the IRS' enforcement action and that taxpayers are informed about and have access to the Taxpayer Advocate Service.
- The IRS must sufficiently test or pilot initiatives that have unknown or unquantifiable impact on taxpayers or unclear benefits to the tax system.

In addition to her day-to-day dealings with IRS program planners and leadership, the National Taxpayer Advocate has several vehicles to influence IRS enforcement initiatives. One is the Taxpayer Rights Impact Statement (TRIS).[5] The TRIS is an assessment of an IRS program or policy by the National Taxpayer Advocate with respect to its impact on taxpayer rights, preferably prior to program implementation. To date, the National Taxpayer Advocate has issued two Taxpayer Rights Impact Statements since she instituted this procedure in July 2004.

A second vehicle for discussing the impact of IRS enforcement initiatives on taxpayer rights is the Annual Report to Congress under IRC § 7803(c). Thus, in this and previous reports, we have discussed in detail several IRS practices that we believe unduly impact taxpayer rights.[6] In the context of the tax gap, we here identify not only possible solutions to the tax gap, particularly with respect to the cash economy, but also the taxpayer rights that such solutions may impair.

Components of the Tax Gap

As noted earlier, the IRS estimates that the annual gross tax gap is approximately $311 billion and the annual net tax gap is about $255 billion.[7] The tax gap consists of several different components – nonfiling ($30.1 billion), underreporting ($248.8 billion), and nonpayment ($31.8 billion). Some of these estimates are more "squishy" than others. For example, the IRS can accurately quantify the amount of tax due on filed returns that

[5] The Taxpayer Rights Impact Statement is discussed in detail in the National Taxpayer Advocate's June 2004 Report to Congress. *See* National Taxpayer Advocate, *Fiscal Year 2005 Objectives Report to Congress*, Publication 4054 (Rev. 8-2004), 2-4.

[6] *See, e.g.*, our discussion of Offers-in-Compromise, Collection Due Process hearings, and Independence of the Office of Appeals, *infra*; our discussion of Combination Letters in the 2003 Annual Report to Congress; and our discussion of Math Error Authority in the 2002 Annual Report to Congress.

[7] *See* IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (Feb. 24, 2004). Note that tax gap information from 2001 is the most recent IRS tax gap data available. In 2005, the IRS will have updated tax gap data from the National Research Program (NRP). The NRP is a comprehensive cross-functional effort by the IRS to measure reporting, filing, and payment compliance for different types of taxes and different groups of taxpayers.

has not been paid. On the other hand, it is difficult to estimate with certainty the underreporting component of the tax gap, since most of its subcomponents are dated. Rigorous research initiatives such as the National Research Program can, of course, improve the accuracy of IRS estimates, particularly in the area of underreported income.

There are two aspects to underreported income: income receipts may be underreported, or deductions, expenses, and tax credits may be overreported. Each of these problems may require different mitigating strategies. Moreover, within each tax gap component, there are different types of taxpayers. Large corporate taxpayers may respond to one type of compliance initiative, which would be completely ineffective if applied to small businesses or the self-employed. High profile investigations of wealthy taxpayer/investors may be a sufficient deterrent to abuse by other high income taxpayers, but education and outreach may be more effective with low income taxpayers.

The single largest component of the tax gap is underreported business income by individuals. Based on the most current IRS data available, \$132 billion – or 42.5 percent – of the \$310 billion gross tax gap for 2001 was attributable to the underreporting of business income by individuals.[8] This underreporting contributed \$81 billion to the individual income tax gap and \$51 billion to the employment tax gap.[9] At a recent hearing on the tax gap held by the Senate Finance Committee, virtually all witnesses agreed that the "cash economy," including sole proprietors, was the biggest category of noncompliance contributing to the tax gap.[10]

A Word About the Cash Economy

For purposes of this report, the "cash economy" refers to cash compensation (including checks) that is not subject to third-party information reporting.[11] We do not use the term to refer to income from an illegal enterprise. In general, the cash economy involves small (even one-person) rather than large enterprises.[12] It also includes individuals who have non-tax reasons for not reporting income, such as undocumented workers or recipients of means-tested government benefits.

8 IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (Feb. 24, 2004). Individual business underreporting has two components – underreporting of actual business receipts and overreporting of business expenses.

9 *Id.*

10 Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 TNT 145-30, (July 8, 2004) (Doc 2004-15394). The assenting witnesses included the Commissioner of Internal Revenue, the Acting Treasury Inspector General for Tax Administration, the Director of Strategic Issues for the Government Accountability Office (GAO), a member of the IRS Oversight Board, Professor Joseph Bankman of Stanford Law School, and the National Taxpayer Advocate.

11 *See* Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript, 2004 TNT 145-30, (July 8, 2004) (Doc 2004-15394), (Q&A of Professor Joseph Bankman) 24.

12 *Id.*

As the witnesses at the Senate hearing noted, no one approach will completely address the tax gap attributable to the cash economy. Most of the witnesses advocated for expanding third-party income reporting, utilization of locally-based data sources such as property tax records and professional or business licenses, and audits designed for a maximum indirect as well as direct effect. Both the Acting Treasury Inspector General for Tax Administration and the General Accountability Office reiterated their support for expansion of third-party withholding on certain payments to self-employed persons.

In her 2003 Annual Report to Congress, the National Taxpayer Advocate listed the Federal tax gap attributable to nonfiling and underreporting by self-employed taxpayers as the second most serious taxpayer problem.[13] Based on the most current IRS data available, self-employed taxpayers accounted for approximately 67 percent of the federal income tax gap and approximately 77 percent of the federal employment tax gap.[14] To be effective, any strategy to reduce the tax gap will have to address noncompliance by this segment of the taxpayer population.

Options for Closing the Tax Gap: Benefit and Burden Analysis

Table 2.8.1 presents some ideas for closing the tax gap. We have divided these ideas into two categories: options that would reduce opportunities for noncompliance, and options that would require the IRS to undertake specific enforcement initiatives. We have also attempted to identify the primary benefits and burdens with respect to each option. Finally, we have applied the approach suggested at the July 2004 Tax Gap Hearing, by labeling each initiative as Most Intrusive (MI), Somewhat Intrusive (SI), and Least Intrusive (LI).

[13] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 20.

[14] IRS National Headquarters Office of Research (unpublished projections furnished for TY 2001.)

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Increased Form 1099-MISC Reporting and Compliance	Increase the Penalty for failing to issue a required Form 1099-MISC (currently the penalty is $50 per return).[15]	SI MI	Increased Form 1099-MISC reporting would reduce some income that currently escapes information reporting (sometimes referred to as the "cash economy".) Increased information reporting results in higher compliance.[16]	Increased 1099-MISC reporting would impose additional burdens on service-recipients that would be required to process and file more paperwork to comply with any additional compliance. Eliminating the "trade or business" requirement for issuing a Form 1099-MISC would impose a new burden on non-business service-recipients, requiring individuals to file information returns on payments for such items as home repairs and yard care.
	Reduce or eliminate the $600 per year threshold for requiring a service recipient to issue a Form 1099-MISC.[17]	MI		
	Reduce or eliminate the $5,000 per year threshold for requiring a Form 1099-MISC to be filed in the case of a direct seller.[18]	LI		
	Require Forms 1099-MISC to be issued to incorporated service providers.[19]	MI		
	Eliminate the "trade or business" requirement for issuing a Form 1099-MISC.[20]	SI		
	Eliminate the "trade or business" requirement for issuing a Form 1099-MISC, but also introduce a high dollar threshold for requiring a service recipient to issue a Form-1099 for non trade or business payments.	MI		

[15] Up to a maximum of $250,000 per year. IRC § 6721(a).

[16] *See* Alan Plumley and C. Eugene Steuerle, "An Historical Look at the Mission of the IRS: What is the Balance between Revenue and Service," 4. *See also*, Most Serious Problem, IRS Examination Strategy, *supra*.

[17] *See* IRC § 6041A(a)(2).

[18] *See* IRC § 6041A(b).

[19] Incorporated service providers are currently exempt from Form 1099-MISC reporting in most cases. *See* Treas. Reg. § 1.6041-3(p)(1).

[20] *See* IRC § 6041A(a)(1).

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Non-Wage Witholding	Require withholding on all payments to service providers that are currently subject to Form 1099-MISC reporting.[21]	MI	Nearly 100 percent of income subject to withholding is reported.[22]	Withholding on current Form 1099-MISC payments would effectively impose employment tax compliance requirements on service recipients for payments to non-employees. Withholding on current Form 1099-MISC payments would require both independent contractors and service recipients to calculate profit margins to estimate the applicable withholding rate. This could impose significant administrative burdens on service recipients that use independent contractors for various kinds of work. It could also impose significant burdens on independent contractors that operate at narrow profit margins.[23]
	Require withholding on all payments to service providers that are currently subject to Form 1099-MISC reporting, and specify that service providers that fail to withhold under this requirement are subject to the Federal Trust Fund Recovery Penalty.[24]	MI		
	Encourage service recipients and independent contractors to enter into voluntary withholding agreements.	LI		
	Provide tax or reduced compliance incentives for service recipients that enter into voluntary withholding agreements with independent contractors.	LI		

[21] *See* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003) 256-269, where this proposal is explained in detail. Several other Federal agencies have also recommended non-wage withholding: see Hearings on H.R. 3245, The Independent Contractor Tax Status Clarification Act of 1979, before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, House of Representatives, 96th Cong. 11 (1979) (statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy); Hearing on Compliance Problems of Independent Contractors, GAO-109909, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, 96th Cong. 7 (1979) (statement of Richard L. Fogel, Associate Director, General Government Division, General Accounting Office); GAO Report to Congressional Requesters, *Tax Administration, Approaches for Improving Federal Contractor Compliance*, GAO/GGD-92-108, 4 (July 1992), General Accounting Office, *Tax Gap: Many Actions Taken, but a Cohesive Compliance Strategy Needed*, GAO/GGD-94-123, 37 (May 11, 1994); GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, *Tax Administration: Tax Compliance of Nonwage Earners*, GAO/General Government Division, GGD-96-165, 12 (August 1996); Treasury Inspector General for Tax Administration, *Significant Tax Revenue May be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors*, Reference No. 2001-30-132, ii (Aug. 2001) *see also*, *Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript*, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Pamela J. Gardiner, Acting Inspector General, Treasury Inspector General for Tax Administration), and Q&A of Mike Brostek, Director Strategic Issues, Government Accountability Office.

[22] *See* Alan Plumley and C. Eugene Steuerle, "An Historical Look at the Mission of the IRS: What is the Balance between Revenue and Service," 4. *See also*, Most Serious Problem, IRS Examination Strategy, *supra*.

[23] *See* generally, Russell A. Hollrah, *Home Care Representative Opposes NTA's Plan to Target Underreporting by Self-Employed*, 2004 T.N.T. 73-37, March 22, 2004.

[24] *See* IRC § 6672. *See also* Key Legislative Recommendation, Small Business Burden Reduction, Protection from Payroll Service Misappropriation, *supra*.

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Increased Backup Witholding	Institute "real time" Taxpayer Identification Number (TIN) verification for service recipients and institute immediate backup withholding on those with invalid TINs.	SI	Expanding the current backup withholding provisions[25] to target specific noncompliance would be less burdensome then general non-wage withholding. Nearly 100 percent of income subject to withholding is reported.	"Real time" TIN verification presents taxpayer information confidentiality concerns.[26] Withholding targeted at noncompliant service providers would still place compliance burdens on the service-recipients that use these service providers. Establishing standards for "demonstrated noncompliance" for both individuals and specific industries could be difficult.
	Require immediate backup withholding on individual service providers who have demonstrated a history on noncompliance.	SI		
	Require immediate backup withholding in specific service industries that have demonstrated a history of noncompliance.	SI		

[25] *See* IRC § 3406.

[26] *See* IRC § 6103.

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Increased Frequency of Estimated Tax Payments	Mandatory Increase	SI	More frequent payments would reduce the likelihood of a self-employed taxpayer expending funds earmarked for taxes on other business or personal expenses and consequently falling out of compliance.[27]	More frequent payments would increase self-employed paperwork and compliance burdens. More frequent payments could impose cash flow constraints on self-employed taxpayers that operate at narrow profit margins.
	Voluntary Increase.	LI		
Voluntary Electronic Estimated Tax Payments	Provide system to allow self-employed taxpayers to electronically submit estimated taxes.	LI	Reduces paperwork and compliance burdens associated with non-electronic payments.Provides a simple means for on-time estimated tax payments, reducing the likelihood of a self-employed taxpayer expending funds earmarked for taxes on other business or personal expenses and consequently falling out of compliance.	Minimal, if any, taxpayer burden.
	Provide system that would allow the IRS to automatically withdraw estimated taxes from a self-employed taxpayer's business checking account. Self-employed taxpayers could participate in this system voluntarily.[28]	LI		

[27] Valerie Chambers, Evidence of Significant Excess Intangible Utility of Increased Intertemporal Payments over Financial Investment Gain Opportunity in a Tax Budgeting Situation (unpublished paper, on file with the Natinonal Taxpayer Advocate), *see also*, *Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript*, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Pamela J. Gardiner, Acting Inspector General, Treasury Inspector General for Tax Administration).

[28] This system could be expanded to impose mandatory withholding through a self-employed taxpayer's business checking account if that taxpayer had demonstrated a history of noncompliance.

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
IRS Audit and Exam Initiatives	Increase "Required Filing Checks" (a.k.a., package audits). Required Filing Checks are part of an IRS field audit and require the IRS agent(s) to examine the records of a business taxpayer to determine such things as whether the taxpayer has filed all required returns – including information returns, if it has submitted questionable Forms W-4, and if it is a "cash business" that may be subject to additional scrutiny.[29]	SI	Increased enforcement increases both direct and indirect compliance.[30] Increased IRS and taxpayer focus on gross receipt sources and Form 1099-MISC reporting. Compliance would increase directly for those taxpayers selected for audits, both for the tax years at issue and for future years. Compliance would increase indirectly as word of these audits spread throughout the respective industries and communities. Outreach, education and research efforts would increase voluntary compliance in selected local areas and market and industry segments.	Taxpayers selected for audits would need to go through IRS examination procedures. Concerns that taxpayers affected by local and national compliance initiatives and recieving disparate treatment compared to non-affected taxpayers.
	Implement local audit initiatives that are focused on income reporting for specific groups of taxpayers with demonstrated histories of noncompliance (for example, contractors in a particular city).[31]	SI		
	Implement national market and industry segment compliance initiatives (including, audits, research, education and outreach, and other compliance initiatives) aimed at increasing voluntary compliance within specific market and industry segments nationwide.[32]	SI		
	Fully utilize IRS Financial Status Analysis and Financial Status Audit techniques to the extent permitted by IRC §7602(e). These techniques seek to identify unreported income by analyzing a taxpayer's cash flows to estimate whether there are sufficient funds to cover the taxpayer's expenses.[33]	SI		

[29] See IRM 4.10.5 (July 13, 2001). On June 27, 2003, the Deputy Director of Compliance Policy for the IRS SB/SE division issued a memorandum limiting the scope of Required Filing Checks by eliminating information return and employment tax return reconciliations and mandatory inspections for questionable Forms W-4. The procedures set forth in this memorandum were to expire on April 15, 2004, but no memorandum to that effect has been issued. Memorandum from SB/SE Deputy Directory, Compliance Policy re Required Filing Checks (package audit) – IRM 4.10.5, June 27, 2003.

[30] *See* Most Serious Problem, Examination Strategy, *supra*.

[31] *See also* discussion in Most Serious Problem, Examination Strategy, *supra*.

[32] These initiatives could be structured to fit within the IRS' Compliance Initiative Projects program. See IRM 4.17.1 (Feb. 1, 2004).

[33] IRM 4.10.4.3.3.1 and IRM 4.10.4.6.1 (June 1, 2004). IRC § 7602(e) limits financial status or economic reality examination techniques to cases where the IRS has a reasonable indication that there is a likelihood of unreported income. The IRM Financial Status Analysis procedures are designed to determine whether such a reasonable indication exists to permit the IRS to implement its Financial Status Audit procedures.

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
IRS Forms Revisions	Revise Form 1040, Schedule C, to include a line item showing the amount of self-employment income that was reported on Forms 1099-MISC.	LI	Receiving specific Form 1099-MISC income information would allow the IRS to better track self-employment income sources and develop measures to reduce the cash economy. Specifically requiring Form 1099-MISC income to be separately reported would increase the likelihood that taxpayers would report such income and also increase taxpayer awareness of income sources that should be reported on Forms 1099-MISC. A "penalties of perjury" statement would make issuers aware of the significance of the Form 1099-MISC requirements and increase awareness that the IRS is actively monitoring accurate Form 1099-MISC compliance and reporting.	Minimal recordkeeping burden.
	Supplement Form 1099-MISC with a required statement that the issuer must sign, under penalties of perjury, declaring that all required Forms 1099-MISC have been issued for the tax year.[34]	LI		

[34] Only one statement would be required per issuer per year. In other words, a Form 1099-MISC issuer would not be required to sign a statement for each Form issued.

TABLE 2.8.1, TAX GAP REDUCTION OPTIONS

General Options	Specific Options	Level of Intrusiveness	Possible Benefits	Possible Burdens
Information Sharing Initiatives	Establish local Compliance Planning Councils, involving the IRS (including both compliance and noncompliance division chiefs and local research offices) and state and local taxing authorities, that would focus on improving self-employed and cash economy compliance in their respective areas.[35]	LI	Self-employed noncompliance and the cash economy affect all levels of government. Information sharing and partnering efforts will allow all government participants to enhance compliance in these areas.[36]	Minimal, if any, taxpayer burden.
	Information sharing between the IRS and state and local taxing, compliance and licensing authorities. These sharing efforts could involve such information as business licenses and property tax records.[37]	LI		

[35] *See also* Most Serious Problem, IRS Examination Strategy, *supra*.

[36] *See Finance Committee Hearing on Tax Gap Recorded in Unofficial Transcript*, 2004 T.N.T. 145-30, July 28, 2004 (Statement of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School).

[37] *See* Testimony of Nina E. Olson, National Taxpayer Advocate, Hearing on Bridging the Tax Gap before the Senate Committee on Finance, July 21, 2004, 10.

RECOMMENDATIONS

LEGISLATIVE RECOMMENDATIONS

ADDITIONAL LEGISLATIVE RECOMMENDATION: EFFECT OF AUTOMATIC STAY IMPOSED IN BANKRUPTCY CASES UPON INNOCENT SPOUSE AND CDP PETITIONS IN TAX COURT

PROBLEM

Internal Revenue Code § 6213(f) tolls the statutory period for filing a petition in the United States Tax Court for the period during which a taxpayer is prohibited from filing such a petition by reason of the automatic stay under the Bankruptcy Code.

There is no analogous provision for Tax Court petitions challenging IRS determinations under IRC §§ 6015 (relief from joint and several liability), 6320 and 6330 (lien and levy collection due process hearings).[1]

EXAMPLES

Innocent Spouse -- IRC § 6015

On September 30, 2003, a taxpayer filed a bankruptcy petition. On January 29, 2004, the IRS issued a Notice of Determination to the taxpayer, disallowing her claim for relief under IRC § 6015. On March 8, 2004, the taxpayer timely filed a "stand-alone petition" with the United States Tax Court to challenge the notice of determination regarding her claim for relief from joint and several liability. At the time the taxpayer filed her Tax Court petition, her bankruptcy case had not been closed or dismissed, and the bankruptcy court had not granted or denied her a discharge. The government filed a motion to dismiss, contending that the Tax Court lacked jurisdiction because the taxpayer filed her petition in violation of the automatic stay. In granting the motion to dismiss for lack of jurisdiction, the Tax Court noted that Congress did not include a tolling provision in IRC. § 6015 comparable to IRC § 6213(f) that would permit a taxpayer to file a petition for redetermination with the Tax Court after the automatic stay is no longer in effect.[2]

CDP -- IRC §§ 6320, 6330

On February 23, 2004, the IRS issued to the taxpayer a Notice of Determination Concerning Collection Action. On March 1, 2004, the taxpayer filed a bankruptcy petition. On March 29, 2004, the taxpayer timely filed a petition with the Tax Court for lien or levy action to challenge the notice of determination. At the time the taxpayer Filed her Tax Court petitioin, her bankruptcy case had not been closed or dismissed, and the bankruptcy court had not granted or denied her a discharge. On March 31, 2004, the bankruptcy court dismissed the taxpayer's bankruptcy case. The government then filed a motion to dismiss in the Tax Court, contending that the Tax Court lacked jurisdiction because the taxpayer filed her petition in violation of the automatic stay. In granting the

[1] Other sections of the IRC may be affected by the lack of a counterpart to IRC § 6213(f), such as interest abatement under IRC § 6404(h), administrative costs actions under IRC § 7430(f)(2), and declaratory judgment actions under IRC §§ 7476 thru 7479. For purposes of this recommendation, however, we have focused only on innocent spouse and CDP, as those are some of the more commonly litigated issues.

[2] *Drake v. Comm'r*, 123 T.C. No. 20 (Dec. 14, 2004).

motion to dismiss for lack of jurisdiction, the Tax Court similarly noted that Congress did not include a tolling provision in IRC §§ 6320 and 6330 comparable to IRC § 6213(f) that would permit a taxpayer to file a petition for redetermination with the Tax Court after the automatic stay is no longer in effect.[3]

In both *Drake* and *Prevo*, the Tax Court recognized that the gap in the procedures "is not one that can be closed by judicial fiat. A remedy, if any, must originate with Congress."[4]

RECOMMENDATION

When the IRS sends a notice of deficiency to a taxpayer, the taxpayer has 90 days (or 150 days if the notice is addressed to a person outside the United States) to file a petition with the Tax Court for a redetermination of the deficiency. In general, the IRS is restricted from either levying or proceeding in court for the collection of the deficiency until the expiration of the 90-day (or 150-day) period within which the taxpayer may file a petition with the Tax Court.[5] Further, if the taxpayer does file a timely petition with the Tax Court, the IRS may neither levy nor proceed in court for collection of the deficiency until the decision of the Tax Court has become final.[6]

When a taxpayer files a bankruptcy petition, the automatic stay arises under 11 U.S.C. § 362 of the Bankruptcy Code.[7] The automatic stay operates to temporarily bar IRS collection proceedings until the stay is either terminated or ceases. In particular, 11 U.S.C. § 362(a)(8) expressly bars "the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor." Thus, the automatic stay prohibits a debtor-taxpayer from filing a petition in the Tax Court once a bankruptcy petition has been filed.[8] Note, however, that 11 U.S.C. § 362(b)(9)(B) provides that the automatic stay does not impact the Service's ability to issue a notice of deficiency.

In any case under 11 U.S.C. (a bankruptcy case), the running of the time prescribed by IRC § 6213(a) (the 90 day or 150 day period) for filing a petition in the Tax Court regarding a deficiency is suspended for the period of time during which the debtor-taxpayer is prohibited by reason of the automatic stay from filing such petition, plus 60 days there-

---

3 *Prevo v. Comm'r*, 123 T.C. No. 21 (Dec. 14, 2004).

4 *Drake*, 123 T.C. No. 20; *Prevo*, 123 T.C. No. 21.

5 IRC § 6213(a).

6 Treas. Reg. § 301.6213-1(a)(2).

7 Actions which are subject to the automatic stay are set forth in 11 U.S.C. § 362(a), which provides in relevant part: (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, . . . operates as a stay, applicable to all entities, of--

> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

8 The automatic stay of Tax Court proceedings affects tax liabilities of the debtor that arise both before and after the bankruptcy petition is filed. *Halpern v. Commissioner*, 96 T.C. 895, 903 (1991).

after.[9] There are certain situations, however, in which a taxpayer can file a petition with the Tax Court when no deficiency is at issue. For example, a taxpayer can file what is known as a "stand-alone petition" with the Tax Court for review of a request for relief from joint and several liability[10] where the IRS has issued a final determination denying a claim for such relief but no tax deficiency was at issue. Similarly, a taxpayer may petition the Tax Court for review of an Appeals determination after a collection due process hearing even though there may be no tax deficiency at issue.[11]

Therefore, the National Taxpayer Advocate recommends that Congress amend IRC §§ 6015, 6320, and 6330 to include language similar to that contained in IRC § 6213(f). In the alternative, Congress should amend each of those sections to include a cross-reference to IRC § 6213, which would provide that rules similar to the rules of IRC § 6213 shall apply for purposes of determining the time for filing a petition.

As yet another option, because there may be other sections of the Internal Revenue Code besides innocent spouse and CDP where the same problem exists, the National Taxpayer Advocate recommends that Congress add a new provision to the Code to make clear that the time for filing a Tax Court petition will be tolled whenever a taxpayer is prohibited from filing such petition by reason of the automatic stay, regardless of whether a deficiency is at issue.

[9] IRC § 6213(f) was added to the Internal Revenue Code in order to coordinate the automatic stay provisions of the Bankruptcy Code with the time for filing a Tax Court petition.

[10] A taxpayer can file Form 8857, Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief), to request relief under I.R.C. § 6015 for a tax year in which he or she filed a joint return. Once the Service issues a Notice of Determination (or if six months have passed from the filing of Form 8857), the taxpayer has 90 days to petition the Tax Court to seek judicial review of the determination. I.R.C. § 6015(e).

[11] A taxpayer can file Form 12153, Request for a Collection Due Process Hearing, to request the Internal Revenue Service Office of Appeals to independently review a lien filed by the IRS or a proposed levy action. If a taxpayer timely requests a hearing, once the Appeals officer issues a Notice of Determination, the taxpayer has 30 days to petition the Tax Court to seek judicial review of the determination. I.R.C. §§ 6320, 6330.

IRS AUTHORITY TO ISSUE REFUNDS AND CREDITS AFTER ENTRY OF TAX COURT DECISIONS

PROBLEM

The IRS is not permitted to issue refunds and credits pursuant to a Tax Court decision in small case proceedings until 90 days after the decision is entered.[1] This is inconsistent with the treatment afforded to Tax Court cases not utilizing the small case proceeding rules and which may be subject to appeal. In those cases, the IRS can issue refunds or credits pursuant to Tax Court decisions after a notice of appeal has been entered, to the extent the overpayment is not contested on appeal.[2] The IRS' inability to issue refunds or credits in small case proceedings before the 90-day period expires subjects some taxpayers to economic hardship.

EXAMPLE

A taxpayer and the IRS have a dispute before the Tax Court and agree to utilize small case proceedings. They reach a settlement pursuant to which the taxpayer is entitled to a refund, which is entered as a Tax Court decision. The taxpayer will be evicted from his home if he does not receive the refund within 30 days after entry of the decision. He is unable to obtain credit secured by his right to the refund. The IRS is willing and able to process and issue the refund in 30 days but is prohibited from issuing it until the expiration of the 90-day period.

RECOMMENDATION

Amend IRC § 6512 to permit the IRS to issue refunds and credits after entry of a Tax Court decision and before it becomes final. This authority should be permissive rather than mandatory so that the IRS is not required to issue the refund or credit if it expects the decision to be vacated before it becomes final.

[1] The IRS cannot issue refunds and credits pursuant to a Tax Court decision until it has become final. IRC § 6512(a). Small cases are not subject to appeal and become final 90 days after a decision is entered. IRC § 7481(b); IRC § 7463(b).

[2] IRC § 6512(a)(6); IRC § 6512(b)(1).

MOST LITIGATED ISSUES: INTRODUCTION

Internal Revenue Code § 7803(c)(2)(B)(ii)(X) requires the National Taxpayer Advocate to identify the 10 tax issues most often litigated in the federal courts, and to classify those issues by the type of taxpayer affected. Through analysis of these issues, the National Taxpayer Advocate will, if appropriate, make recommendations designed to mitigate disputes that result in litigation. We recognize that many taxpayers litigate issues because of legitimate interpretative and factual disputes of law, while others institute litigation in order to delay the collection process. The recommendations included in this analysis could minimize some of the litigation covered in this section.[1]

The Taxpayer Advocate Service worked with the IRS Office of Chief Counsel to identify the issues most frequently litigated. Our office researched a commercial database for decisions filed for each issue by the United States Tax Court, the federal district courts, the United States Court of Federal Claims, and the United States bankruptcy courts during the period of June 1, 2003, through May 31, 2004. For this analysis and report, the term "litigated" is defined as a case with a published decision by the court. This does not mean that the taxpayer has exhausted the judicial appeals process.

In 2002, we expanded the Most Litigated Issues section of this report by giving a more detailed and comprehensive analysis of the cases than in any previous Annual Report to Congress. In 2003, we improved our reporting with the addition of a "*Summary*" section for each issue analyzed, providing the reader a brief and easy-to-understand synopsis of the detailed analysis. The analysis follows and includes a description of the current law, a breakdown of cases litigated, and a conclusion. Recommendations for specific legislative and administrative changes are incorporated in the conclusions, as appropriate.

We listed each of the cases litigated, by issue, in Appendix 2 of this report and have categorized the cases by type of taxpayer. The case listings for each issue identify the specific citation of the case, a brief synopsis of the issue, whether the taxpayer was represented at trial by counsel or argued the case pro se, and the decision of the court. The "decision" of the court is identified as a decision for the taxpayer, for the IRS, or as a split decision. For purposes of this analysis, only the issue analyzed was considered when identifying the decision of the court, and a split decision was defined as a partial allowance of the specific issue litigated.

[1] For example, Collection Due Process (CDP) is again the number one Most Litigated Issue this year. The National Taxpayer Advocate is making a legislative recommendation to improve the CDP hearing procedure in order to enhance taxpayer understanding and taxpayer satisfaction with the CDP hearing process. With increased understanding and satisfaction in the CDP hearing process, taxpayers will be less likely to undertake the lengthy and costly litigation process. *See* this report, Key Legislative Recommendation, *supra*.

AN OVERVIEW OF HOW TAX ISSUES ARE LITIGATED

Taxpayers generally have access to four different tribunals in which to initially litigate a tax matter – the United States Tax Court, United States district courts, the United States Court of Federal Claims, the United States bankruptcy courts. With limited exceptions, taxpayers have an automatic right of appeal from decisions of the trial court and any subsequent appeals are granted at the discretion of the appellate courts.[2]

The United States Tax Court is generally a "prepayment" forum in that taxpayers have access to the Tax Court without having to pay the disputed tax in advance. The Tax Court has exclusive jurisdiction over deficiency cases in income, estate and gift tax and certain excise tax controversies,[3] as well as certain declaratory judgment actions.[4] The Tax Court also has exclusive jurisdiction in appeals from Collection Due Process (CDP) hearings where jurisdiction for the underlying tax belongs in the Tax Court.[5] For example, CDP appeals involving income tax matters are litigated in the Tax Court, while CDP appeals involving payroll tax matters are litigated in the district courts.[6]

The U.S. district courts and the Court of Federal Claims have concurrent jurisdiction over tax matters in which (1) the tax has been assessed and paid in full,[7] and (2) the taxpayer has filed an administrative claim for refund.[8] The U.S. District Courts are the only forums in which a taxpayer can receive a jury trial. Bankruptcy courts can adjudicate tax matters that involve a debtor's open tax years and were not previously adjudicated before the initiation of a bankruptcy case.[9] In certain instances, there is shared jurisdiction among these courts.[10]

[2] *See* IRC § 7482 (providing that the United States Courts of Appeals have jurisdiction to review the decisions of the Tax Court). There are exceptions to this general rule. For example, IRC § 7463 provides special procedures for small Tax Court cases (where the amount of tax, additions to tax, interest, and some penalties in controversy totals $50,000 or less) from which appellate review is not available. See also 28 U.S.C.A. § 1294 (appeals from district court are to the appropriate U.S. Court of Appeal); 28 U.S.C.A. § 1295 (appeals from Court of Federal Claims are heard in the Federal Circuit Court).

[3] *See* IRC § 6214.

[4] *See* IRC § 7430 (Tax Court has jurisdiction to review awards of costs and fees); IRC § 7476 (Tax Court has jurisdiction to hear declaratory judgments on qualifications of certain retirement plans).

[5] IRC §§ 6320(c) and 6330(d).

[6] *Voelker v. Nolen*, 365 F.3d 580 (7th Cir. 2004) (holding Tax Court had exclusive jurisdiction concerning taxpayer's complaints about CDP process in income tax case); *Render v. Comm'r*, 309 F.Supp.2d 938 (E.D. Mich. 2003) (holding proper jurisdiction for employment tax was district court).

[7] 28 U.S.C.A. § 1346(a)(1). *See Flora v. United States*, 362 U.S. 145 (1960).

[8] IRC § 7422(a).

[9] *See* 11 U.S.C.A. §§ 505(a)(1) and (a)(2)(A).

[10] IRC § 7428 confers concurrent jurisdiction on the Court for Federal Claims, the United States Tax Court, and the U.S. district courts to review government decisions regarding the tax-exempt status of an organization.

MOST LITIGATED

MOST LITIGATED TAX ISSUES

Each of the courts has specific rules regarding procedures and evidence. The Tax Court and U.S. Court of Federal Claims are national courts; the Tax Court holds trial calendars in 62 cities.[11] In contrast, the Federal district and bankruptcy courts are local courts, sitting in judicial districts throughout the nation.

The taxpayer's choice of judicial forum depends on many factors, including the court's procedures, the burden of proof, and the controlling precedent. As noted above, if the Tax Court has subject matter jurisdiction over the taxpayer's case, he or she can litigate without paying the tax in advance but must file the petition within the prescribed 90 days from the date of the Notice of Deficiency.[12]

ANALYSIS OF *PRO SE* LITIGATION

As in the previous two years, our analysis indicated that many taxpayers represented themselves before the courts, *pro se.*[13] The following table (Table I-01) lists the most litigated tax issues for the period June 1, 2003, through May 31, 2004, and identifies the number of cases in which taxpayers represented themselves before the court.

TABLE I-01, *PRO SE* CASES BY ISSUE

Most Litigated Issued	Total Number Of Litigated Cases Reviewed	Pro Se Litigation	Percentage of Pro Se Cases
Collection Due Process	182	137	75%
Earned Income Tax Credit	28	22	79%
Failure to File Penalty	47	35	74%
Family Status Issues	44	41	93%
Frivolous Issues Penalty	35	30	86%
Income Issues	102	63	62%
Joint and Several Liability	62	36	58%
Accuracy-Related Penalty for Negligence	54	29	54%
Trade or Business Expenses	68	41	60%
Trust Fund Recovery Penalty (TFRP)	26	3	12%
Total	**648**	**437**	**67%**

This table indicates that the issues with the highest rate of *pro se* taxpayers are Family Status Issues, Frivolous Issues Penalties, and the Earned Income Tax Credit. These statistics are important because they demonstrate two important facts about litigation in the tax matters. First, litigants who need counsel most, *i.e.* low income taxpayers who struggle with the complexities inherent in the Internal Revenue Code, are those who are least represented. Second, the lack of representation fosters the litigation of frivolous issues, which in turn contributes to the administrative burdens of the IRS and the court system.

[11] The Tax Court holds trial sessions in 14 additional cities for cases involving up to $50,000 in dispute per tax year.

[12] IRC § 6213(a). A petitioner who is outside of the United States at the time the Notice of Deficiency is mailed has 150 days within which to file a petition with the Tax Court.

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

The rate in which taxpayers prevail in litigation also tells us something about our tax system. Table I-02 illustrates the number and percentage of cases where *pro se* and represented taxpayers prevailed in each of the issues considered by the courts.

TABLE I-02, OUTCOMES FOR *PRO SE* AND REPRESENTED TAXPAYERS

	Pro Se Taxpayers			*Represented Taxpayers*		
Most Litigated Issue	**Total Cases**	**Taxpayer Prevailed in whole or in part**	**Percent**	**Total Cases**	**Taxpayer Prevailed in whole or in part**	**Percent**
Collection Due Process	137	5	4%	45	5	11%
Earned Income Tax Credit	22	6	27%	6	1	17%
Failure to File Penalty	35	1	3%	12	0	0%
Family Status Issues	41	9	22%	3	0	0%
Frivolous Issues Penalty	30	2	7%	5	0	0%
Income Issues	63	5	8%	39	9	23%
Joint and Several Liability	36	9	25%	26	7	27%
Accuracy-Related Penalty for Negligence	29	4	14%	25	6	24%
Trade or Business Expenses	41	3	7%	27	14	52%
Trust Fund Recovery Penalty (TFRP)	3	1	33%	23	7	30%
Totals	**437**	**45**	**10%**	**211**	**49**	**23%**

Table I-02 demonstrates that taxpayers have a higher chance of prevailing in litigation if they are represented. What is perhaps more telling is the small number of taxpayers who actually prevail in their disputes with the IRS. Taxpayers expend substantial time and resources to litigate their obligations under the tax code and rarely prevail. The government also expends substantial resources to defend this litigation. Both of the tables shown above, along with much of the other analysis contained within this report, suggest that the complexity of the tax system is reflected in the most litigated issues and constitutes a continuing burden on both taxpayers and the government, and this problem needs to be addressed.

LITIGATED

ISSUE #1

MOST LITIGATED ISSUE: COLLECTION DUE PROCESS (CDP)

SUMMARY

The Collection Due Process hearing, established by the IRS Restructuring and Reform Act of 1998, provides taxpayers an opportunity for independent review of a lien filed by the IRS or a proposed levy action.[1] The taxpayer may raise certain issues at the hearing, including the appropriateness of collection actions, collection alternatives, spousal defenses, and under certain limited circumstances, the underlying tax liability.[2]

As in 2003, Collection Due Process was the most frequently litigated tax issue in the Federal courts during the period analyzed for the Annual Report to Congress, although the number of CDP cases litigated decreased this year. The decisions reflect an increase in cases decided for the IRS, a decrease in dismissed cases, and a significant decrease in cases where taxpayers presented frivolous arguments. Seventy-five percent of the CDP cases were brought before the courts by the taxpayer without the benefit of counsel (i.e., *pro se*), down from 88 percent in the previous report. The decisions also reflect a continued confusion on the part of taxpayers about many aspects of the CDP hearing process.

PRESENT LAW

Current law provides taxpayers an opportunity for independent review of a lien[3] filed by the IRS or a proposed levy action.[4] The IRS Restructuring and Reform Act of 1998 ("RRA 98") established the Collection Due Process (CDP) hearing to extend the protections taxpayers have in dealing with other creditors to their dealings with the Internal Revenue Service.[5]

The IRS sends a notice to the taxpayer's last known address by certified or registered mail, notifying him or her of the opportunity to request a CDP hearing.[6] The taxpayer must return a signed, written request for a hearing within 30 days of the date of notice.[7] Unless

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

[2] IRC §§ 6320(c) and 6330(c).

[3] IRC § 6320.

[4] IRC § 6330.

[5] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3401, 112 Stat. 685; S. Rep. No. 105-174.

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

[7] IRC §§ 6320 (a)(2)(C) and 6330(a)(2)(C); Treas. Reg.§§ 301.6320-1(c)(2), Q&A-C1 and 301.6330-1(c)(2), Q&A-C1. The Internal Revenue Service has recently approved the expanded use of faxes for receiving information and documents from taxpayers and practitioners. Form 12153, Requests for Collection Due Process Hearing, can be accepted by fax if contact has been made with the taxpayer by phone or in-person and the taxpayer history file is documented with the date of contact and notation is made that the taxpayer wishes to send the document, form, or letter by facsimile. Internal Revenue Service Memorandum, "New Policy for Use of Fax and Signatures Stamps in Taxpayer Submissions", June 24, 2003.

the IRS has reason to believe collection of the tax is in jeopardy, the IRS will stop levy action during the 30-day period.[8]

When a taxpayer requests CDP hearings with respect to both a lien and a proposed levy, the IRS Appeals officer will conduct one hearing.[9] If the taxpayer's request is timely filed, the IRS will suspend collection action throughout the process.[10] Internal Revenue Code § 6330(e)(1) requires the statutory collection period to be suspended until the date the Appeals determination is final or the taxpayer withdraws the request for a hearing.[11]

The issues a taxpayer may raise at a CDP hearing include one or more of the following issues relating to the unpaid tax:

- Appropriateness of collection actions;[12]
- Collection alternatives such as installment agreement, offer in compromise, posting a bond or substitution of other assets;[13]
- Appropriate spousal defenses;[14] and
- The existence or amount of the tax, but only if the taxpayer did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the tax liability.[15]

The taxpayer may not reintroduce an issue that was raised and considered at a prior administrative or judicial hearing, if the individual participated meaningfully in the prior hearing or proceeding.[16]

Collection Due Process hearings are informal. Depending on the preference of the taxpayer, the hearing can be conducted face-to-face, by telephone, or by correspondence.[17] The hearing is to be held by an impartial officer from the Appeals function of the IRS.[18] Within 30 days of the Appeals determination, the taxpayer may petition the United States Tax Court or where appropriate, the U.S. District Court.[19] The notice of determination, which sets forth Appeals' findings and decisions, provides instructions for appealing the decision, including the court of jurisdiction.[20]

8 IRC § 6330(a).

9 IRC § 6320(b)(4).

10 IRC § 6330(e)(1).

11 IRC§ 6330(e)(1), and Treas. Reg. §§ 301.6320-1(g)(1) and 301.6330-1(g)(1).

12 IRC §§ 6330(c)(2)(A)(ii) and 6320(c).

13 IRC §§ 6330(c)(2)(A)(iii) and 6320(c).

14 IRC §§ 6330(c)(2)(A)(i) and 6320(c).

15 IRC §§ 6330(c)(2)(B) and 6320(c).

16 IRC §§ 6330(c)(4) and 6320(c).

17 Treas. Regs. §§ 301.6320-1(d)(2), Q&A-D6 and 301.6330-1(d)(2), Q&A-D6.

18 IRC §§ 6320(b)(1), 6320(b)(3), 6330(b)(1) and 6330(b)(3).

19 IRC §§ 6330(d)(1) and 6320(c).

20 Treas. Reg. §§ 301.6320-1(f)(2), Q&A-F3 and 301.6330-1(f)(2), Q&A-F3.

The legislative history of RRA 98 addresses the standard of review courts should apply in reviewing the IRS' administrative CDP determinations.[21] Where the validity of the tax liability is properly at issue in the CDP hearing, the amount of the liability will be reviewed by the appropriate court on a *de novo* basis.[22] Where the appropriateness of the collection action is at issue, the court will review the IRS' administrative determination for abuse of discretion.[23]

ANALYSIS OF LITIGATED CASES

Collection Due Process was the most litigated tax issue in the Federal court system between June 1, 2003, and May 31, 2004. One hundred eighty-two CDP decisions were published by the courts during this period, nine percent fewer than the 199 CDP cases reported in the previous 12 months.[24] Table 1 in Appendix 2 provides a detailed listing of litigated CDP cases, including specific information about the types of taxpayers involved.

Favorable outcomes for taxpayers in Appeals from CDP hearings cases continued to decline this year. Table 3.1.1 below compares court decisions for the 2002, 2003, and 2004 Reports to Congress in categories of cases decided for the IRS, dismissed, [25] decided for the taxpayer, remanded to Appeals or decided in part for the taxpayer and in part for the IRS ("split decision"[26]). This table reflects a continued increase in decisions in favor of the IRS and a decrease in dismissed cases.

TABLE 3.1.1, COURT DECISION COMPARISON

Court Decisions	2002 Percentage	2003 Percentage	2004 Percentage
Decided for IRS	54%	73%	81%
Dismissed	36%	23%	14%
Decided for Taxpayer	3%	1%	1%
Split Decision	3%	3%	1%
Remanded Back to Appeals	4%	0%	3%

[21] H.R. Rep. No.105-599 at 266.

[22] The term *de novo* means anew. *Black's Law Dictionary*, 447 (7th ed. 1999).

[23] The phrase *abuse of discretion* means an adjudicator's failure to exercise sound, reasonable, and legal decision making; an appellate court's standard for reviewing a decision that is asserted to be grossly unsound, unreasonable or illegal. *Black's Law Dictionary*, 10 (7th ed. 1999). For discussion of the abuse of discretion standard, see the following cases: *Woodral v. Comm'r*, 112 T.C. 19, 23 (1999); *Fargo v. Comm'r*, T.C. Memo. 2004-13; *Razo v. Comm'r*, T.C. Memo. 2004-101.

[24] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003) 318.

[25] Dismissals are those decisions where the court dismissed the case or granted the motion to dismiss because (1) the taxpayer failed to state a claim upon which relief could be granted, (2) the taxpayer was late in requesting a CDP hearing or petitioning the court, (3) the court otherwise lacked jurisdiction, and (4) other miscellaneous reasons.

[26] This analysis considered a "split decision" as one where part of the decision favored the taxpayer and part of the decision favored IRS.

CDP cases litigated in Federal courts involved both the procedural aspects of CDP hearings, and substantive legal issues unrelated to the CDP hearing process. The National Taxpayer Advocate has identified the lack of appropriate administrative procedures in CDP hearings as a Most Serious Problem affecting taxpayers for the past two years.[27] In this report, the National Taxpayer Advocate proposes revisions to the CDP hearing process in a Key Legislative Recommendation.[28]

CDP PROCEDURAL ISSUES

Procedural issues raised by CDP participants generally fall into one of seven categories:

- Whether the taxpayer was in the right court;
- Whether the taxpayer satisfied filing requirements;
- Whether taxpayer received a face-to-face hearing;
- Whether taxpayers are permitted to tape record the hearing;
- Whether the taxpayer was permitted to raise the underlying liability;
- Whether the IRS abused its discretion in considering collection alternatives; and
- Whether taxpayer's change in circumstances should be considered.

Which Jurisdiction Controls?

As the *pro se* analysis demonstrates below, taxpayers are often unrepresented in CDP hearings. One byproduct that flows from the lack of representation is that taxpayers, who are often unfamiliar with the mechanics of litigation, must determine for themselves what legal documents need to be filed in which courts. Appeals from CDP hearings present an added layer of confusion because appeals from income tax cases are made to the Tax Court, while appeals from employment related taxes are made to the appropriate U.S. district court.[29] Appeals to the Tax Court are termed *petitions*[30] and the forms are accessible from the Tax Court Internet site.[31] Appeals to the U.S. district courts are termed *complaints*;[32] and there are no readily available forms for *pro se* taxpayers to use in appeals from CDP cases. As a result of this confusion, numerous appeals from CDP hearings were

[27] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104, 38 (Rev. 12-2003); National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), 110.

[28] *See* this report, *supra*.

[29] IRC §§ 6330(d)(1) and 6320(c).

[30] U.S. Tax Court R. 20(a).

[31] *See* http://www.ustaxcourt.gov.

[32] Fed. R. Civ. P. 7(a).

filed in the wrong court.[33] Congress should continue its efforts to centralize CDP hearings in the Tax Court.[34]

Have Filing Requirements Been Satisfied?

A number of cases involved the taxpayer's failure to make timely filing requirements under either of the two 30-day filing deadlines,35 (i.e. the 30-day deadline for requesting a CDP hearing36 and the 30-day deadline for requesting an appeal to the Tax Court or the U.S. district court, as appropriate, after issuance of the notice of determination).37 As these cases demonstrate, courts cannot provide a taxpayer relief where the deadlines are missed. For example in Carmichael v. Commissioner, the taxpayer failed to request a hearing after receiving the first IRS notice of intent to levy.38 Upon receipt of a second notice, the taxpayer requested a CDP hearing, which the IRS did not grant. On appeal, the court determined that the taxpayer lost the right to a CDP hearing upon the lapse of the 30 days after receiving the first notice, and dismissed the case.39

What Type of Hearing is Required?

Taxpayers continue to litigate over the type of CDP hearing granted.[40] The Treasury Regulations present conflicting information as to the nature of the CDP hearing. For example, one part of the regulations suggests that the hearing need not be conducted

[33] *Fingado v. Mares*, 92 A.F.T.R.2d (RIA) 6283 (D. N.M. 2003) (dismissing case brought against IRS Appeals officers for alleged deficiencies in CDP process because jurisdiction belonged in U.S. Tax Court); *Porter v. U.S.*, 91 A.F.T.R.2d (RIA) 946 (9th Cir. 2003) (affirming dismissal since Tax Court had proper jurisdiction rather than District Court); *Hart v. U.S.*, 291 F.Supp.2d 635 (N.D. OH 2003); *Randle v. U.S.*, 92 A.F.T.R.2d (RIA) 5542 (E.D. PA 2003) (holding Tax Court was proper forum); *Render v. Comm'r*, 309 F.Supp.2d 938 (E.D. Mich. 2003) (holding case would not be dismissed from District Court even though dismissal from wrongly filed Tax Court petition had not yet been ruled upon); *Voelker v. Nolen*, 365 F.3d 580 (7th Cir. 2004) (holding Tax Court had exclusive jurisdiction concerning taxpayer's complaints about CDP process in income tax case); *Desire Community Housing Corp. v. U.S.*, 93 A.F.T.R.2d (RIA) 1463 (E.D. La. 2004) (in case where taxpayer was represented, court held issues raised about CDP hearing process were exclusive jurisdiction of Tax Court); *Perkins v. U.S.*, 314 F.Supp.2d 664 (E.D. Tex. 2004) (holding Tax Court had exclusive jurisdiction); and *Brown v. Doran*, A.F.T.R.2d (RIA) 7409 (M.D. N.C. 2003) (holding District Court has no jurisdiction over CDP issues).

[34] The Tax Administration Good Government Act, S. 882, Section 301, 108th Cong. (2004), contains a provision to centralize CDP hearings in the Tax Court.

[35] *Medical Psychiatric Association v. U.S.*, 91 A.F.T.R.2d (RIA) 2733 (N.D. Tex. 2003) (holding court has no jurisdiction where deadline is missed); *Cabirac v. Comm'r*, 92 A.F.T.R.2d 5269 (E.D. Pa. 2003) (taxpayer failed to request CDP hearing and therefore, court had no jurisdiction).

[36] IRC §§ 6330(a)(3) and 6320(a)(3).

[37] IRC §§ 6330(d)(1) and 6320(c).

[38] *Carmichael v. Comm'r*, 93 A.F.T.R.2d (RIA) 1026 (D. N.J. 2004).

[39] *Id*. It is important to note that the Treasury Regulations do provide an "equivalent hearing" for taxpayers who fail to make a timely request for a CDP hearing; however, there is no right to further appeal from an equivalent hearing. Treas. Reg. § 301.6330-1(i)(1).

[40] *See Cavanaugh v. U.S.*, 93 A.F.T.R.2d (RIA) 1522 (D. N.J. 2004).

face-to-face but may be the exchange of correspondence.[41] In a subsequent provision, however, the regulations appear to indicate the taxpayer will receive a face-to-face hearing upon request.[42] A number of cases illustrate the confusion taxpayers experience regarding this issue.[43] For example, in *Cavanaugh v. U.S.*, the taxpayer requested a face-to-face hearing; however, the IRS took the position that the CDP hearing had taken place during a telephone conference with the taxpayer and that a face-to-face hearing was not required even when requested by the taxpayer.[44] The court held that the Appeals officer abused her discretion in denying the face-to-face hearing, especially in light of the fact that the taxpayer claimed he did not even know that the telephonic hearing was (in the IRS's view) his CDP hearing.

Recent policy shifts suggest that the IRS is seeking to minimize the number of face-to-face hearings, which may have the effect of further litigation in this area. First, the IRS Office of Appeals has initiated a process of sending a letter to taxpayers who request hearings that presumptively establishes the CDP hearing as a telephonic proceeding, and the taxpayer will receive a face-to-face hearing only if he or she specifically makes the request.[45] Second, Appeals has initiated a process of sending some CDP case files to IRS campuses, which will remove cases from the taxpayer's geographic location.

[41] Treasury Regulation §301.6330-1(d), Q-D6 & A-D6 provides as follows:

A CDP hearing may, but is not required to, consist of a face-to-face meeting, one or more written or oral communications between an Appeals officer or employee and the taxpayer or the taxpayer's representative, or some combination thereof.

[42] Treasury Regulation §301.6330-1(d)(2), Q-D7 & A-D7 provides as follows:

Q-D7. If a taxpayer wants a face-to-face CDP hearing where will it be held?

A-D7. The taxpayer must be offered an opportunity for a hearing at the Appeals office closest to taxpayer's residence or, in the case of business taxpayers, the taxpayer's principal place of business. If that is not satisfactory to the taxpayer, the Appeals officer or employee will review the taxpayer's request for a CDP hearing, the case file, any other written communications, if any, submitted in connection with the CDP hearing), and any notes of any oral communications with the taxpayer or the taxpayer's representative. Under such circumstances, review of those documents will constitute the CDP hearing for the purposes of section 6320(b).

[43] *Tilley v. U.S.*, 270 F.Supp.2d 731 (M.D. N.C. 2003) (holding telephone hearing is sufficient); *Stewart v. Comm'r*, 93 A.F.T.R.2d (RIA) 1463 (W.D. Pa. 2003) (holding no face to face hearing is required).

[44] *Cavanaugh v. U.S.*, 93 A.F.T.R.2d (RIA) 1522 (D. N.J. 2004).

[45] Internal Revenue Service, Letter 3855 (03/04).

Is Tape Recording of CDP Hearing Permitted?

The right of a taxpayer to tape record CDP hearings was an issue raised in a number of cases during the period reviewed for this analysis.[46] The Treasury Regulations provide:

> A transcript or recording of any face-to-face meeting or conversation between an Appeals officer or employee and the taxpayer or the taxpayer's representative is not required.[47]

In *Keene v. Commissioner*, however, the Tax Court held that IRC § 7521[48] requires Appeals officers to permit recordings of the CDP hearing if the taxpayer requests it and provides the necessary recording equipment. [49] Other courts have declined to follow the Tax Court's ruling in *Keene*.[50] In conformity with *Keene*, the IRS should amend the Treasury Regulations to clarify that taxpayers have the right to record their CDP hearings, and the IRS should advise taxpayers of this important right. In the regulations, of course, the IRS can clarify that the request to record must be made timely and cannot be made as a way to unduly delay the proceedings.

[46] *Keene v. Comm'r*, 121 T.C. 8, 17 (2003); *Fingado v. U.S.*, 92 A.F.T.R.2d 6283 (D. N. M. 2003) (holding District Court did not have jurisdiction to hear taxpayer's complaint about being precluded from recording hearing); *McDonald v. U.S.*, 92 A.F.T.R.2d (RIA) 7197 (N.D. Tex. 2003) (failure to allow recording is not an abuse of discretion where taxpayer raised only frivolous issues); *Snyder v. Comm'r*, 93 A.F.T.R.2d 2004-425 (N.D. Ohio 2003) (taxpayer does not have a right to record CDP hearing); *Norsworthy v. U.S.*, 93 A.F.T.R.2d 1700 (W.D. Tex. 2004) (taxpayer does not have a right to request hearing when taxpayer could not contest liability); *Yuen v. U.S.*, 209 F. Supp. 2d 1220 (D. Nev. 2003) (no right to record where taxpayer was making frivolous arguments); *Brashear v. Comm'r*, T.C. Memo. 2003-196 (taxpayer may have a right to remand but not necessary to remand in this case); *Kemper v. Comm'r*, T.C. Memo. 2003-195 (no right to record where issues raised are frivolous); *Horton v. Comm'r*, T.C. Memo. 2003-197 (no right to record where issues raised by taxpayer are frivolous).

[47] Treas. Reg. §301.6320-1(d) A-D6 and Q-D6.

[48] IRC § 7521 permits taxpayers to record any "interview" with IRS personnel relating to the determination or collection of a tax.

[49] *Keene v. Comm'r*, 121 T.C. 8, 17 (2003).

[50] *Boyd v. U.S.*, 322 F.Supp.2d 1229 (D. N.M. 2004) (holding that IRC section 7521 does not apply to CDP hearings).

What Issues May Be Raised at a CDP hearing?

Many taxpayers also do not understand what issues may be argued under which circumstances in appeals from CDP hearings. Taxpayers attempted to argue the underlying liability in many cases when they had either received a notice of deficiency or previously had an opportunity to argue the tax and therefore were not permitted to reopen that issue.[51]

In one important case, however, the Tax Court clarified the scope of issues that taxpayers can raise at a CDP hearing where the taxpayer has self-assessed the tax liability on his or her tax return. In *Montgomery v. Commissioner*, the IRS argued that in a CDP hearing the taxpayer cannot challenge liabilities that the taxpayer self-assesses on his or her own tax return. [52] The Tax Court held that the taxpayer is entitled to argue the underlying liability at a CDP hearing in the case of self-assessment because the taxpayer did not receive a notice of deficiency from the IRS and did not have any other opportunity to argue the underlying liability after assessment.[53] As a result of the *Montgomery* decision, the IRS has provided its employees guidance to comply with the decision.[54]

Was Collection Action Lawful?

Internal Revenue Code §§ 6330(c)(2)(A)(ii) and 6320(c) specify that taxpayers may raise the appropriateness of collection actions at a CDP hearing. In a number of cases, taxpayers asserted that the proposed collection action was unlawful because of an IRS procedural defect.[55] In *Hyler v. U.S.*, a U.S. district court addressed some of the different issues

[51] *Plettner v. U.S.*, 92 A.F.T.R.2d 5762 (N. D. Ill. 2003) (holding officer of company previously had opportunity to dispute liability under IRC section 6672 and was unable to argue the matter at his CDP hearing); *Johnson v. U.S.*, 92 A.F.T.R.2d 7233 (N.D. Ga. 2003) (holding officer of company previously had opportunity to dispute liability under IRC section 6672 and was unable to argue the matter at his CDP hearing); *Ordunez v. U.S.*, 92 A.F.T.R.2d 6297 (9th Cir. 2003) (taxpayer had received Notice of Deficiency); *Tolotti v. Comm'r*, 70 Fed. Appx. 971 (9th Cir. 2003) (taxpayer had received Notice of Deficiency); *White v. U.S.*, 92 A.F.T.R.2d 5179 (W.D. Wash. 2003) (holding officer of company previously had opportunity to dispute trust fund liability under IRC section 6672); *Miller v. U.S.*, 93 A.F.T.R.2d 1148 (E.D. Pa. 2004) (holding officer of company previously had opportunity to dispute trust fund liability under IRC section 6672); *Leiter v. U.S.*, 93 A.F.T.R.2d 793 (D. Kan. 2004) (holding officer of company previously had opportunity to dispute trust fund liability under IRC section 6672); *Dixon v. Comm'r*, T.C. Summ. Op. 2003-149 (taxpayer had received Notice of Deficiency); *Sciola v. Comm'r*, T.C. Memo. 2003-334 (taxpayer had received Notice of Deficiency); *Alvarez v. Comm'r*, T.C. Memo. 2003-319 (taxpayer had received Notice of Deficiency); *Thomas v. Comm'r*, T.C. Memo. 2003-231(taxpayer had received Notice of Deficiency); *Smith v. Comm'r*, T.C. Memo. 2003-205 (taxpayer received Notice of Deficiency); *Aaron v. Comm'r*, T.C. Memo. 2004-65 (although court acknowledged this taxpayer had many hardships, taxpayer had received Notice of Deficiency and so could not argue underlying liability); *Burbridge v. Comm'r*, T.C. Memo. 2004-88 (taxpayer received Notice of Deficiency, so could not argue underlying liability); *Milam v. Comm'r*, T.C. Memo. 2004-94 (taxpayer received Notice of Deficiency, so could not argue underlying liability); *Robertson v. Comm'r*, T.C. Memo. 2004-72 (taxpayer could argue underlying liability for years where no Notice of Deficiency received); and *Nicol v. Comm'r*, T.C. Summ. Op. 2004-47 (taxpayer received Notice of Deficiency so cannot argue liability).

[52] *Montgomery v. Comm'r*, 122 T.C.1 (2004). Montgomery, in which five judges dissented, was a full court-reviewed decision, i.e. where the full Tax Court reviews the decision; thus, the case has value as precedent before the Tax Court.

[53] *Montgomery v. Comm'r* 122 T.C. 1 (2004).

[54] IRM 8.7.2.3.11(6).

[55] *Hyler v. U.S.*, 93 A.F.T.R.2d (RIA) 1976 (N.D. Cal. 2004); *Daugherty v. Comm'r*, 93 A.F.T.R.2d (RIA) 648 (10th Cir. 2004); *Boyer v. Comm'r*, T.C. Memo. 2003-322 (holding certificate of lien release does not extinguish tax liability).

frequently raised in appeals from CDP hearings.[56] The taxpayer, at a CDP hearing, attempted to raise the underlying liability of a Trust Fund Recovery Penalty under IRC § 6672 for trust fund taxes that the taxpayer's business failed to pay. The IRS determined that the taxpayer already had an opportunity to raise the issue with the Office of Appeals and was not entitled to raise the issue of the underlying liability. The taxpayer filed an appeal of the notice of determination to the Tax Court. The Tax Court dismissed the case because it lacked jurisdiction over employment taxes. The taxpayer then filed with the appropriate district court; however, in the interim, the IRS had levied on the taxpayer's property in satisfaction of the trust fund taxes. The district court ruled that the taxpayer's allegation as to the lawfulness of the levy action was now moot because the IRS had already levied in satisfaction of the debt.[57]

Did the IRS Abuse Its Discretion in Rejecting a Collection Alternative?

Internal Revenue Code §§ 6330(c)(2)(A)(iii) and 6320(c) specify that taxpayers may raise collection alternatives at a CDP hearing. A taxpayer can challenge the IRS decision on the collection alternative under an abuse of discretion standard. However, the cases litigating this issue demonstrate the formidable burden of proof upon a taxpayer, under this standard, and courts will generally sustain the IRS determination if its administrative procedures were followed by Appeals. [58] In *Ramirez v. Commissioner*, however, the Tax Court held it was an abuse of discretion for an Appeals officer to fail to refuse consideration of an offer in compromise that was in the possession of the Appeals officer prior to the issuance of the notice of determination.[59]

[56] *Hyler v. U.S.*, 93 A.F.T.R.2d (RIA) 1976 (N.D. Cal. 2004).

[57] *Id.*

[58] *Magnolia Media Group Ltd. v. U.S.*, 93 A.F.T.R.2d (RIA) 340 (N.D. Tex. 2003) (not an abuse of discretion to reject installment agreement when taxpayer had breached two previous agreements); *Living Care Alternatives of Utica, Inc. v. U.S.*, 93 A.F.T.R.2d 2004-761 (S.D. Ohio 2003) (no abuse of discretion to reject collection alternative); *Mayben v. U.S.*, 92 A.F.T.R.2d 5071 (D. Nev. 2003); *Wall v. Comm'r*, T.C. Summ. Op. 2003-165 (while rejection of collection alternative can be an abuse of discretion, no abuse of discretion existed here); *Willis v. Comm'r*, T.C. Memo. 2003-302 (since taxpayer had income, tax was not currently uncollectible and it was proper to reject offer-in-compromise); *Van Vlaenderen v. Comm'r*, T.C. Memo. 2003-346 (no abuse of discretion in rejection of offer-in-compromise); *Johnson v. Comm'r*, T.C. Memo. 2004-73 (extreme hardship does not aid taxpayer in appeal from rejection of offer-in-compromise, where taxpayer failed to take all necessary actions); *Dwain v. Comm'r*, T.C. Summ. Op. 2004-44 (holding levy action inappropriate and remanding case to Appeals to properly countenance omitted year's taxes from installment agreement); *Ramirez v. Comm'r*, T.C. Summ. Op. 2004-48 (holding it was an abuse of discretion for Appeals officer not to review offer-in-compromise which was received after deadline but before issuance of Notice of Determination); *Clawson v. Comm'r*, T.C. Memo. 2004-106 (not an abuse of discretion for Appeals officer not to consider effect of September 11, 2001 terrorist attacks on ability to sell assets).

[59] *Ramirez v. Comm'r*, T.C. Summ. Op. 2004-48.

Should Change in Circumstances be Considered?

In appeals from CDP hearings, courts are confronted with two different legal issues related to a taxpayer's change in the taxpayer's circumstances:

- Whether the IRS must consider a taxpayer's change in circumstances during a CDP hearing; and
- Whether a court has the authority to consider a taxpayer's change in circumstances if evidence of the change was not before the Appeals officer.

In *Cavanaugh v. United States*, the U.S. district court remanded the case back to Appeals for a CDP hearing that would include an opportunity for the taxpayer to present evidence of changed financial circumstances, to support his offer in compromise of less than what the IRS determined he could pay.[60] The IRS argued that as a matter of policy it does not consider changed circumstances because if it were required to do so, devious taxpayers could make these claims repeatedly and avoid paying taxes indefinitely. The court noted that changed financial circumstances are relevant to a proposed levy, and interpreted the statutory language to require that Settlement Officers consider taxpayers' claims of changed financial circumstances at CDP hearings.[61]

The Tax Court has also ruled that the IRS must consider a taxpayer's change in circumstances when evaluating an offer in compromise. In *Ashurst v. Commissioner*, the taxpayers claimed on appeal from their CDP hearing that their circumstances had changed dramatically, and requested their case be sent back to Appeals for a reconsideration of their offer.[62] The Tax Court ordered the case returned to consider the change in circumstances, though it retained jurisdiction of the case. After Appeals reconsidered the case, it determined that the taxpayers' offer in compromise should not be accepted. The Tax Court ruled that the subsequent determination by Appeals was not an abuse of discretion.[63]

Courts have been less willing to consider a taxpayer's change in circumstances if the evidence was not provided at the CDP hearing. For example, in *Living Care Alternatives of Utica, Inc. v. U.S.*, the U.S. District Court noted that its jurisdiction was limited to a review of the administrative record before the Appeals officer. [64] Similarly, in *Chandler v. Commissioner*, the U.S. Tax Court stated that the petitioner's claims of current financial hardship could not be considered in the proceeding because they were not raised before the Appeals officer. [65] These cases reflect the importance of taxpayers placing all pertinent facts before the IRS Appeals officer. These cases also demonstrate that the IRS' concerns

[60] *Cavanaugh v. U.S.*, 93 A.F.T.R.2d (RIA) 1522 (D. N.J. 2004).

[61] *Id.*

[62] *Ashurst v. Comm'r*, T.C. Summ. Op. 2004-14.

[63] *Id.*

[64] *Living Care Alternatives of Utica, Inc., v. U.S.*, 93 A.F.T.R.2d (RIA) 761(S.D. Ohio 2004).

[65] *Chandler v. Comm'r*, T.C. Memo. 2004-7.

about taxpayers continuously raising changed circumstances in order to perpetually keep a case in litigation are not well founded.

Was Opportunity for CDP Hearing Denied?

CDP cases occasionally involve the issue of whether the statutory right to a CDP hearing was effectively denied to the taxpayer. For example, in *Brown v. Commissioner*, the taxpayer requested a CDP hearing following receipt of notices of intent to levy for tax years 1995 and 1996.[66] The taxpayer requested a CDP hearing and entered into discussions with the Appeals officer in advance of the hearing. IRS records reflected that a notice of deficiency was issued for the tax year 1996. The taxpayer attempted to raise the underlying liability of interest and penalties with the Appeals officer, but was told not to bother attending any hearing if his intent was to dispute the underlying liability.[67] The Tax Court held that the taxpayer was denied his right to a hearing and remanded the case to Appeals so that the taxpayer could receive his CDP hearing.[68]

SUBSTANTIVE LEGAL ISSUES

The cases described above primarily involved issues unique to the CDP process. Because any relevant issue can be raised at a CDP hearing (provided the taxpayer has not previously had an opportunity to raise the issue), substantive legal issues unrelated to the CDP hearing process are also litigated in CDP hearings, including the following issues:

- Whether taxes were discharged in bankruptcy;[69]
- Whether the Federal tax lien on assets exempt from bankruptcy survived bankruptcy;[70]
- Whether assets of the bankruptcy estate were applied against the tax liability;[71]

[66] *Brown v. Comm'r*, T.C. Summ. Op. 2004-45, supplemented by *Brown v. Comm'r*, T.C. Summ.Op. 2004-130.

[67] *Id.*

[68] *Id.*

[69] *Swanson v. Comm'r*, 121 T.C. 111 (2003) (holding that the tax liabilities were not discharged in bankruptcy because the substitute for returns prepared by the IRS did not constitute filed returns for purposes the Bankruptcy Code, the taxpayer did not file his required returns, and as a result, the tax liabilities were excepted from discharge within the meaning of under 11 U.S.C. § 523(a)(1)(B) (2000)). *See also Ramsdell v. Comm'r*, T.C. Memo. 2003-317.

[70] *Iannone v. Comm'r*, 122 T.C. 287 (2004) (holding that the existing Federal tax lien was not extinguished as a result of the bankruptcy discharge and rejecting the taxpayer's contention that his retirement account was exempt from levy); *Fusaro v. Comm'r*, T.C. Memo. 2003-345 (holding that the taxpayer's pension plan, although exempt property in the bankruptcy proceedings, was subject to collection by the IRS because a valid Notice of Federal Tax Lien had been filed prior to the bankruptcy). Pursuant to 11 U.S.C.A. § 522(C)(2)(B), the IRS may pursue collection of certain assets exempt from bankruptcy proceedings. For example, if the IRS has filed a Notice of Federal Tax Lien against a taxpayer's home prior to the bankruptcy proceeding, the IRS may pursue collection action on that property, even though the tax liabilities are discharged against the taxpayer personally in the bankruptcy proceeding. *Also see* IRM 25.17.2.9.1.1 (Rev. 07-01-2002).

[71] *Wingert v. Comm'r*, T.C. Memo. 2003-172, (finding the taxpayer provided no credible evidence that $5,243 of his bankruptcy estate was applied to pay his 1994-1996 taxes).

- Whether the statute of limitations period for collection had expired when the final notice of intent to levy was issued;[72]
- Whether overpayments and offsets were properly applied;[73]
- Issues related to notices of Federal tax lien (NFTL), such as correct place for filing a NFTL, perfecting the lien filing, effectiveness of liens, and real estate title and lien attachment;[74]
- Whether criminal prosecutions extinguish civil liabilities;[75]
- Payment applications by the IRS;[76]
- Interest abatement issues;[77] and
- Trust Fund Recovery Penalty (TFRP) issues;[78]

Pro Se Analysis

Seventy-five percent (137) of the 182 cases litigated were brought before the courts by the taxpayer, *pro se*, without benefit of counsel. This is a decrease from 88 percent in the previous year.[79] At least part of the decline is due to the reduced number of taxpayers that requested CDP hearings and raised only frivolous issues.[80] The percentage of frivolous fil-

[72] IRC § 6502(a)(1) defines the collection period as ten years from the time the tax liability is assessed. *See Gnifkowski v. Comm'r*, 93 A.F.T.R.2d (RIA) 1159 (D. Minn. 2004) (holding that the offer in compromise filed by the taxpayer tolled the collection statute); *Roberts v. Comm'r*, T.C. Memo. 2004-100 (finding that the Form 900 (Tax Collection Waiver) was valid. Even if the taxpayer had signed a blank Form 900 (Tax Collection Waiver), his failure to repudiate the extensions, complain about any irregularity in their execution, and his numerous payments pursuant to an installment agreement with IRS, which effectively forestalled enforced collection action against him, demonstrate that the waivers were valid and not improperly obtained).

[73] *Rabinovich v. Comm'r*, T.C. Summ. Op. 2003-126, (holding that IRC § 6511(a) barred the application of overpayments to the taxpayer's outstanding liabilities).

[74] *Goldman v. Comm'r*, T.C. Memo. 2004-3 (finding that the taxpayers were the true owners of real estate in Florida, and as a result, the IRS did not abuse its discretion in rejecting the taxpayers' offer in compromise).

[75] *Gnifkowski v. U.S.*, 93 A.F.T.R.2d (RIA) 1159 (D. Minn. 2004) (holding that the taxpayer's civil liability was not extinguished as part of the criminal proceeding).

[76] *Gnifkowski v. U.S.*, 93 A.F.T.R.2d (RIA) 1159 (D. Minn. 2004) (holding that the IRS properly exercised its discretion when it applied the funds collected via levies to the non-Trust Fund Recovery Penalty tax liabilities).

[77] *Leiter v. U.S.*, 93 A.F.T.R.2d (RIA) 793 (D. Kan. 2004) (holding that the IRS did not abuse its discretion in denying the request for abatement of interest, and the taxpayer provided no evidence of a ministerial or managerial act of the IRS causing a delay).

[78] The Trust Fund Recovery Penalty (TFRP) is a penalty provided by IRC § 6672 against any person required to collect, account for, and pay over taxes held in trust who willfully fails to perform any of these activities. The penalty is equal to the total trust fund portion, i.e. employee's portion, amount of tax evaded, not collected, or not accounted for and paid over. *See* IRM 5.7.3.1 (3) (Rev. 12-1-2003). *See Leiter v. U.S.*, 93 A.F.T.R.2d (RIA) 793 (D. Kan.2004), (holding that the taxpayer's liability for the TFRP was separate and distinct and he was potentially liable for the entire amount). *See also* this report, Most Litigated Issue, *Trust Fund Recover Penalty*, *infra*.

[79] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 322.

[80] The criteria used to identify a case as frivolous were: (1) an IRC § 6702 penalty (commonly referred to as frivolous return penalty) upheld by the court, (2) an IRC § 6673 sanction asserted by the Tax Court (or Appeals Court), or (3) the court labeling the arguments presented by the taxpayer as frivolous.

ers dropped from 52 percent (in the previous year) to 23 percent;[81] of this group, 85 percent were *pro se*. The 45 cases in which taxpayers retained representation involved 22 individual and 23 business taxpayers.

The National Taxpayer Advocate believes that legal representation is vital to a taxpayer who is engaged in litigation or is contemplating litigation against the IRS. IRS employees should be trained to advise taxpayers about the benefits of counsel representation. For those who qualify, Low Income Taxpayer Clinic assistance and other available legal aid may help the taxpayers to better understand why the collection actions taken in their cases were appropriate.

Table 3.1.2 shows the breakdown of *pro se* and represented taxpayers and the decisions rendered by the court, indicating that approximately 97% of *pro se* taxpayers receive no relief in appeals from CDP hearings.

TABLE 3.1.2, *PRO SE* & REPRESENTED TAXPAYERS IN CDP CASES

	Taxpayer Pro Se		*Representation*	
Court Decisions	**Volume**	**Percentage Of Total**	**Volume**	**Percentage Of Total**
Decided for IRS[82]	132	96%	40	89%
Decided for Taxpayer[83]	2	2%	4	9%
Split Decision	3	2%	1	2%
Totals	**137**	**100%**	**45**	**100%**

CONCLUSION

The CDP hearing process continues to be the subject of much litigation. Recent procedural decisions, such as the movement toward conducting CDP hearings via telephone[84] and not informing taxpayers of their right to audio record a hearing,[85] could increase litigation, as may the handling of CDP cases in the IRS campus (service center) environment. Further, it is anticipated that increased IRS collection activity will bring more requests for CDP hearings. Finally, the significant reduction (from 52 percent last year to 23 percent this year) in frivolous CDP cases being brought before the courts demonstrates that the CDP process is beginning to be utilized in the manner for which it was intended.

81 National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Revision 12-2003), 328.

82 Included in this number are appeals from CDP hearings that were dismissed by courts, as all of the dismissals were favorable to the IRS.

83 Included in this number are cases remanded back to the Office of Appeals, as all remands except one were providing the taxpayer the relief requested. In *Harrell v. Commissioner*, the Tax Court rejected the taxpayer's argument that the Appeals officer had abused her discretion but remanded the case to Appeals to give the taxpayer an opportunity to submit a collection alternative. This case was reported as a split decision. *Harrell v. Comm'r*, T.C. Memo. 2003-271.

84 Internal Revenue Service, Letter 3855 (03/04). The letter presumes a telephonic hearing, placing the obligation on the taxpayer to contact Appeals within 14 days to request a face-to-face hearing.

85 *Keene v. Comm'r*, 121 T.C. 8, 19 (2003) (stating the taxpayer was entitled to record his CDP hearing with the Appeals office). IRS Publication 1660 does not inform taxpayer of this right.

LITIGATED ISSUE #2 MOST LITIGATED ISSUE: INCOME ISSUES, IRC § 61

SUMMARY

The issue of what constitutes gross income for purposes of Internal Revenue Code (IRC) § 61 is again one of the Most Litigated Issues this year, as it has been since 1998, the first year that the National Taxpayer Advocate was required to report on the ten most litigated issues.[1] All of the cases involve income that taxpayers failed to report. This analysis organizes these cases by the arguments made by taxpayers in litigation against the IRS. In general, taxpayers presented four different arguments, though there is some overlap:

- the items fell outside of the definition of gross income contained in IRC § 61;
- the method used by the IRS to determine income was invalid;
- the item of income was excluded by another IRC provision; or
- the income was taxable to a different taxpayer.

PRESENT LAW

IRC § 61 broadly defines gross income as "all income from whatever source derived." [2] Income is taxable to the person who earns it,[3] with the limited exception that in certain situations income is taxable to the person who has the right to receive payments, such as divisions of property pursuant to a divorce.[4] Additionally, a number of other Code sections impact both how the IRS determines unreported income and what constitutes gross income. In 2004, IRC § 61 was most often litigated in concert with either IRC § 446(b) or 104(a)(2). IRC § 446(b) allows the IRS to reconstruct taxpayer income using all reasonable methods; IRC § 104(a)(2) excludes certain funds attributable to damages from personal injury awards. As these code sections are factors in many of the litigated cases, additional analysis is warranted.

[1] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, Title 1, Subtitle A, § 1102(a), 112 Stat 685, required that the 10 most litigated issues be reported on in the National Taxpayer Advocate's *Annual Report to Congress*.

[2] IRC § 61(a) provides as follows:

a) General definition.–Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; (8) Alimony and separate maintenance payments; (9) Annuities; (10) Income from life insurance and endowment contracts; (11) Pensions; (12) Income from discharge of indebtedness; (13) Distributive share of partnership gross income; (14) Income in respect of a decedent; and (15) Income from an interest in an estate or trust.

[3] *Lucas v. Earl*, 281 U.S. 111 (1930) (holding income taxed to husband notwithstanding husband's anticipatory assignment of income to wife).

[4] *Pfister v. Comm'r*, 359 F.3d 352 (4th Cir. 2004).

IRC § 446(b)

Internal Revenue Code § 446(b) provides that the IRS may reconstruct the taxpayer's income by any method that is reasonable under the circumstances when the taxpayer does not maintain adequate books or records.[5] The reconstruction need not be exact but reasonable and substantially correct.[6] Taxpayers in litigation sometimes argued only that the method used by the IRS was invalid.[7] In other cases, taxpayers also argued that the item identified by the IRS did not fall within the definition of income, *i.e.* it was a loan or a gift.[8]

IRC § 104(a)(2)

IRC § 104 provides an exclusion from gross income for amounts received on account of certain personal injuries or sickness, including amounts received through workers' compensation claims, personal injury suits, and accident or health insurance.[9] The most frequent source of litigation has been IRC § 104(a)(2) which excludes from gross income damages received on account of a personal injury. In *Schleier v. Commissioner*, the Supreme Court established a two-part test for exclusion of damages from gross income: (1) the underlying claim must be based in tort, and (2) the amount of any damages received must be granted on account of personal injury or sickness. The test's two elements are independently considered such that the taxpayer must satisfy both elements of the test.[10] In 1996, the Small Business Job Protection Act of 1996 (SBJPA) modified IRC § 104(a)(2) to limit the exclusion to *physical* personal injuries.[11] The *Schleier* test still applies to post-

[5] IRC § 6001 requires taxpayers to maintain adequate books and records. When taxpayers have failed to maintain adequate records, the IRS can utilize any reasonable method to arrive at the taxpayer's taxable income. *Petzholdt v. Comm'r*, 92 T.C. 661, 687 (1989).

[6] *Petzholdt v. Comm'r*, 92 T.C. 661, 687 (1989).

[7] *Medlin v. Comm'r*, T.C. Memo. 2003-224.

[8] *Merritt v. Comm'r*, 301 F.2d 484, 486 (5th Cir. 1962), *aff'g*. T.C. Memo. 1959-172 (1963).

[9] IRC § 104 provides exclusions as follows:

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;

(3) amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer);

(4) amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a disability annuity payable under the provisions of section 808 of the Foreign Service Act of 1980; and

(5) amounts received by an individual as disability income attributable to injuries incurred as a direct result of a terroristic or military action (as defined in section 692(c)(2)).

[10] *Schleier v. Com'r*, 515 U.S. 323, 337 (1995).

[11] The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1838.

SBJPA cases but the second part of the test now requires proof that the personal injuries or sickness for which the damages were received were physical.[12]

Miscellaneous Exclusion Provisions

Other provisions litigated in concert with IRC § 61 included:

- IRC § 931 – This section excludes from gross income funds earned in a United States possession by a person who was a resident in the possession for the entire taxable year.[13] A conflict between the statute and the regulations has given rise to litigation concerning the status of Johnston Island (see analysis below).
- IRC § 86 – This section governs the extent to which Social Security benefits are taxed, excluding certain taxpayers and requiring other taxpayers to calculate what portion of benefits are taxable pursuant to a formula.
- IRC §§ 104(a)(3) and (4) – IRC § 104(a)(3) excludes certain payments from accident or health insurance relating to personal injuries. IRC § 104(a)(4) excludes payments to members of armed services and certain other government services on account of personal injuries.
- IRC § 105 - This section excludes from gross income payments for loss of use of a member of the body or function, provided the payments are calculated by reference to such loss of use.

ANALYSIS OF LITIGATED CASES

Our review covers the cases that included income as an issue and were decided in the Federal courts between June 1, 2003, and May 31, 2004. Fifty cases involved taxpayers asserting that funds at issue did not fall within the definition of gross income under IRC § 61 or where the taxpayer had no defense for underreporting income.[14] In 14 cases, taxpayers asserted that the method used to determine income was invalid. Thirty-one cases involved taxpayers asserting that the items at issue were excluded by another IRC section, of which 19 involved IRC § 104(a)(2). Seven cases dealt with the issue of to whom income was taxable.

Definition of Gross Income

Federal courts continued to reaffirm the broad definition of gross income set out in *Commissioner v. Glenshaw Glass Co.*[15] (income includes "any accession to wealth"). During the reporting period, cases considered whether a wide spectrum of taxpayer funds and

[12] *Shaltz v. Comm'r*, T.C. Memo. 2003-173; *Henderson v. Comm'r*, T.C. Memo. 2003-168; *Prasil v. Comm'r*, T.C. Memo. 2003-100.

[13] IRC § 931 defines a U.S. possession as Guam, American Samoa, and the Northern Mariana Islands, whereas Treasury Regulation § 1.931-1 includes Johnston Island as a U.S. possession.

[14] In some of these cases, the taxpayer simply failed to report income and in litigation offered no argument for why items were not income. *Bonner v. Comm'r*, T.C. Summ. Op. 2004-34; *Brusman v. Comm'r*, T.C. Memo. 2003-291; Grow v. Comm'r, T.C. Op. 2003-114.

[15] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955).

benefits constitute gross income under IRC § 61, including gambling winnings,[16] awards,[17] retirement income,[18] Social Security benefits,[19] cancellation of indebtedness income,[20] and a professional football seat license.[21] The issue in these cases was whether a specific item of income fell within the definition of gross income under the circumstances. The IRS prevailed in all of these cases, in many of which the IRS' position was strengthened by information returns provided to the taxpayers by third parties and filed with the IRS. For example, in *Armstrong v. Commissioner*, a credit card company issued the taxpayer a Form 1099-C and sent a copy to the IRS, which compared the taxpayer's tax return against his corresponding information returns and issued a notice of deficiency for the unreported cancellation of debt income.[22] The IRS prevailed in all cases where the item of income in dispute was included on an information return.

In six cases, courts determined that the arguments made by taxpayers were so contrary to well established principles of law as to justify the imposition of penalties under IRC § 6673 in the Tax Court or comparable provisions in United States district courts[23] for making frivolous arguments.[24] Taxpayers in these cases made arguments such as the assertion that wages do not constitute taxable income.[25] These taxpayers were all *pro se*, *i.e.* without the benefit of legal counsel. It is worth noting here these cases constitute a sharp decline from the 39 cases (87 percent) analyzed in the previous year.[26]

[16] *Berardi v. Comm'r*, 92 A.F.T.R.2d (RIA) 5669 (3rd Cir. 2003); *Imberger v. Comm'r*, T.C. Summ. Op., 2003-156; *Dubois v. Comm'r*, T.C. Memo. 2003-222.

[17] *Roco v. Comm'r*, 121 T.C. 160 (2003).

[18] *Bunce v. Comm'r*, T.C. Summ. Op. 2003-141; *Gilmore v. Comm'r*, T.C. Summ. Op. 2004-50; *Bunce v. Comm'r*, T.C. Summ. Op. 2003-141.

[19] *Weaver v. Comm'r*, T.C. Summ. Op., 2003-216 (holding taxation of Social Security benefits is not unconstitutional); *Davis v. Comm'r*, 2003-323.

[20] *Anderson v. Comm'r*, T.C. Summ. Op. 2003-169; *Armstrong v. Comm'r*, T.C. Summ. Op. 2003-90.

[21] *Kerns v. Comm'r*, T.C. Memo. 2004-63.

[22] In *Armstrong v. Comm'r*, T.C. Summ. Op. 2003-90, the taxpayer (an independent contractor) argued that the debt was acquired in a construction project, for which he was never paid. Because he was never paid for the construction work, the taxpayer argued that he received no economic benefit from the cancellation of debt; however, the Tax Court held that the entire amount forgiven by the taxpayer was taxable under Treasury Regulations § 1.61-12(a).

[23] 28 U.S.C.A. § 1927 (providing sanctions against attorneys in Federal courts for unduly multiplying and delaying proceedings); 28 U.S.C.A. § 1912 (providing that costs and damages can be assessed against a party for taking frivolous appeal); Fed. R. Civ. P. 11(b) (providing for sanctions against any person for advancing arguments or claims that have no basis or serve only to harass).

[24] *Ciciora v. Comm'r*, T.C. Memo. 2003-202; *Frey v. Comm'r*, T.C. Memo. 2004-87; *Rayner v. Comm'r*, 92 A.F.T.R.2d (RIA) 5151 (5th Cir. 2003); *Spurlock v. Comm'r*, T.C. Memo. 2003-248; *Wos v. Comm'r*, T.C. Memo. 2004-66; Evans v. U.S., 92 A.F.T.R.2d (RIA) 6703 (E.D. Pa. 2003).

[25] *Ciciora v. Comm'r*, T.C. Memo. 2003-202.

[26] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Revision 12-2003), 336-338. Notwithstanding this decline in income cases where the courts assessed IRC § 6673 frivolous argument penalties, frivolous penalty cases are the 8th Most Litigated Issue this year (while there were only five income frivolous penalty cases, there were other cases involving different frivolous issues raised by taxpayers which justified the imposition of the IRC § 6673 penalty). See this report, *infra*.

METHODS OF DETERMINING INCOME

In cases where the IRS does not have information returns to rely on, it must often reconstruct the taxpayer's income using indirect methods. In a pattern similar to the one detailed in the 2002 Annual Report to Congress,[27] 14 cases involved the IRS' application of IRC § 446(b) to reconstruct taxpayers' income by use of various indirect methods, such as the "bank deposits method,"[28] the "cash expenditures method,"[29] and the "specific item method"[30] through which the IRS identifies funds that are assumed to constitute gross income unless the taxpayer can prove they originate from a nontaxable source.[31] Taxpayers failed to rebut the presumption in favor of the IRS' determination in all of the cases except one.[32] The failure of the taxpayers to keep adequate records to substantiate their positions was a substantial factor in all of these cases.

EXCLUSIONS FROM INCOME

IRC § 104(a)(2)

Nineteen cases involved the issue whether settlement proceeds from lawsuits or potential lawsuits are excludable from income under IRC § 104(a)(2).[33] These cases frequently turned on the second part of the IRC § 104(a)(2) test: whether the proceeds were paid to compensate the taxpayer for a physical personal injury. These cases were primarily decided

[27] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 341-42.

[28] When using the "bank deposits" method, the IRS reconstructs the taxpayer's true income by analyzing deposits and assuming deposits are from a taxable source unless the taxpayer can demonstrate otherwise. *Medlin v. Comm'r*, T.C. 2003-224.

[29] The cash expenditures method is based on the assumption that the amount by which a taxpayer's expenditures during a taxable period exceed his reported income has taxable origins, absent some explanation by the taxpayer. *Valdes v. Comm'r*, T.C. Summary Opinion 2004-19; *Burgo v. Comm'r*, 69 T.C. 729, 742 (1978).

[30] The "specific item" method is an indirect method of income reconstruction, which consists of evidence of specific amounts of income received by a taxpayer and not reported on the taxpayer's return. *Kovacevich v. Comm'r*, T.C. Memo. 2003-161; *Estate of Beck v. Comm'r*, 56 T.C. 297 (1971).

[31] *Gaines v. Comm'r*, T.C. Summ. Op. 2003-127; *Hamilton v. Comm'r*, T.C. Memo. 2004-78; *Williams v. Comm'r*, T.C. Memo. 2003-216; *Valdes v. Comm'r*, T.C. Summ. 2004-19; *Sowards v. Comm'r*, T.C. Memo. 2003-180; *Rice v. Comm'r*, T.C. Memo. 2003-208; *Medlin v. Comm'r*, T.C. Memo. 2003-224; *Maciel v. Comm'r*, T.C. Memo. 2004-28; *Kovacevich v. Comm'r*, T.C. Memo. 2003-161; *Howard v. Comm'r*, T.C. Summ. Op. 2003-124; *Demetree v. Comm'r*, T.C. Memo. 2003-323; *Estate of Kanter v. Comm'r*, 341 F.3d 364 (5th Cir. 2003); *McCarron v. Comm'r*, T.C. Summ. Op. 2004-13; *Price v. Comm'r*, T.C. Memo. 2004-103.

[32] *Demetree v. Comm'r*, T.C. Memo. 2003-323, holding that, as to some items in dispute, the taxpayer was able to document nontaxable loans with promissory notes and was able to demonstrate a pattern of gift giving from family members.

[33] *Amos v. Comm'r*, 2003-329; *Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003), cert. granted, 124 S.Ct. 1712, 158 L.Ed.2d 398 (2004); *Banks v. Comm'r*, 345 F.3d 373 (6th Cir. 2003), cert. granted, 124 S.Ct. 1712 (2004); *Cotterell v. Comm'r*, T.C. Summ. Op. 2003-145; *Dorroh v. Comm'r*, T.C. Summ. Op. 2003-93; *Gerard v. Comm'r*, T.C. Memo. 2003-320; *Henderson v. Comm'r*, T.C. Memo. 2003-124; *Johnson v. Comm'r*, 92 A.F.T.R.2d (RIA) 5969 (10th Cir. 2003); *Knoll v. Comm'r*, T.C. Memo. 2003-277; *Lindsey v. Comm'r*, T.C. Memo. 2004-113; *Lockmiller v. Comm'r*, T.C. Summ. Op. 2003-108; *McCann v. Comm'r*, 93 A.F.T.R.2d. (RIA) 851 (5th Cir. 2004); *Medina v. Comm'r*, T.C. Summ. Op. 2003-148; *Murray v. Comm'r*, T.C. Summ. Op. 2003-60; *Oyelola v. Comm'r*, T.C. Summ. Op. 2003-28; *Polone v. Comm'r*, T.C. Memo. 2003-339; *Shaltz v. Comm'r*, T.C. Memo. 2003-173; *Tamberella v. Comm'r*, T.C. Memo. 2004-47; *Venable v. Comm'r*, T.C. Memo. 2003-240.

under IRC §104(a)(2), as amended by the 1996 SBJPA, which narrowed the exclusion from gross income to damages received on account of *physical* injuries, thereby eliminating the previous exclusion for damages received for emotional distress related to or caused by tort-based claims.[34] However, six cases were decided under the pre-SBJPA law (which did not contain the requirement that the injury be a *physical injury*).[35] The SBJPA amendment to IRC §104(a)(2) survived several attacks on its constitutionality.[36]

In deciding whether payments are made to a taxpayer to compensate for physical personal injuries, courts look to the intent of the party making the payment as evidenced by a number of factors, including the content of the settlement agreement (if any),[37] factual allegations made by the taxpayer,[38] and whether there is a direct causal link between the damages and the physical injuries.[39] In only three of the 19 cases could taxpayers convince the Tax Court that some portion of the damages were eligible for the IRC §104(a)(2) exclusion.[40]

Attorney Fees in Contingency Cases

A related income issue arose in three IRC §104 cases:[41] whether contingent attorneys' fees are taxable to the client-taxpayer upon a judgment or settlement. This issue was highlighted in the 2002 *Annual Report to Congress* in which the National Taxpayer Advocate made a

[34] *Henderson v. Comm'r*, T.C. Memo. 2003-168.

[35] These cases were primarily decided under the SBJPA amendments to IRC § 104(a)(2): *Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003), cert. granted, 124 S.Ct. 1712, 158 L.Ed.2d 398 (2004); *Banks v. Comm'r*, 345 F.3d 373 (6th Cir. 2003), cert. granted, 124 S.Ct. 1712 (2004); *Gerard v. Comm'r*, T.C. Memo. 2003-320; *Knoll v. Comm'r*, T.C. Memo. 2003-277; *McCann v. Comm'r*, 93 A.F.T. R2d (RIA) 851 (5th Cir. 2004); and *Polone v. Comm'r*, T.C. Memo. 2003-339 (as to payments made in 1996 decided under the pre-SBJPA).

[36] *Venable v. Comm'r*, T.C. Memo. 2003-240 (holding limited retroactivity of SBJPA amendments was not unconstitutional); *Lockmiller v. Comm'r*, T.C. Summ. Op. 2003-108 (holding that SBJPA amendments did not violate taxpayer's due process rights).

[37] In *Amos v. Comm'r*, T.C. Memo. 2003-329, the Tax Court looked first to the settlement agreement which was silent as to allocation among damage components; therefore, the court looked next to the underlying allegations and concluded that 67 percent of the award was excludable from gross income. However, a settlement agreement which allocates to physical personal injuries solely for tax reasons will not be respected by the courts. *Knoll v. Comm'r*, T.C. Memo. 2003-277.

[38] *Shaltz v. Comm'r*, T.C. Memo. 2003-173 (factual allegations related to harassment claim are not physical injuries).

[39] *Banaitis v. Comm'r*, 340 F.3d 1074, 1080 (9th Cir. 2003), *cert. granted*, 124 S.Ct. 1712, 158 L.Ed.2d 398 (2004).

[40] *Amos v. Comm'r*, T.C. Memo. 2003-329; *Gerard v. Comm'r*, T.C. Memo. 2003-320; *Polone v. Comm'r*, T.C. Memo. 2003-339.

[41] *Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003), cert. granted, 124 S.Ct. 1712, 158 L.Ed.2d 398 (2004) (holding fees not taxable); *Banks v. Comm'r*, 345 F.3d 373 (6th Cir. 2003), cert. granted, 124 S.Ct. 1712 (2004) (holding fees not taxable); *Murray v. Comm'r*, T.C. Summ. Op. 2003-60. The issue also arose in *Raymond v. Comm'r*, 355 F.3d 107 (2nd Cir. 2003) (IRC § 104 was not an issue in this case and the court held that contingency attorneys' fees are taxable to the plaintiff-taxpayer).

legislative recommendation regarding the treatment of these fees for tax purposes.[42]

The cases litigating this issue involve taxpayers who were paid damages attributable to nonphysical personal injuries arising out of a tort based claim.[43] The issue often arises in cases involving IRC § 104 because they frequently involve taxpayers who obtain judgments or settlements in tort based claims and seek exclusion under IRC § 104(a)(2). The taxpayers in personal injury cases typically have contingency fee arrangements with their attorneys.[44] Under the IRS position in these cases, the full amount of the recovery must be included in gross income and the attorney fee portion deducted as a "miscellaneous itemized deduction."[45] Miscellaneous itemized deductions, however, are subject to the two percent floor in IRC § 67 and more importantly, cannot be deducted for purposes of the alternative minimum tax (AMT).[46] If a taxpayer cannot demonstrate that the damages are eligible for exclusion under IRC § 104(a)(2), both the actual amounts received by the taxpayer and the related attorneys' fees will be taxable to the client-taxpayer, at times resulting in grossly inequitable results.[47]

The IRS has asserted the "assignment of income" doctrine as a basis to hold client-taxpayers liable for the contingent attorneys' fees,[48] and has prevailed in a number of United States Courts of Appeal that have addressed the issue.[49] Other Federal Courts of Appeal

[42] In the 2002 *Annual Report to Congress*, the National Taxpayer Advocate made a legislative recommendation for including legal fees awarded in nonphysical personal injury settlements and judgments in gross income and allowing a corresponding deduction from gross income under IRC § 62. National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev 12-2002), 162; *see also* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev 12-2003), 347-350, for discussion of issue in Most Litigated Issues section.

[43] For full discussion, *see* National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev 12-2002), 612.

[44] *Id*.

[45] *Biehl v. Comm'r*, 351 F.3d 982, 984 (9th Cir. 2003). In *Biehl*, the taxpayers won a large settlement in a wrongful termination case, $401,000 of which went to attorneys' fees, all taxable to the taxpayers. The taxpayers could not get the benefit of a miscellaneous itemized deduction (a "below-the-line" deduction) because the alternative minimum tax added the amount back into income. Consequently, the taxpayers tried to deduct attorneys' fees from gross income as a trade and business expense under IRC § 62 (an "above-the-line" deduction). The court affirmed the Tax Court's disallowance of the deduction in holding that the fees were not "in connection with" taxpayer's business.

[46] IRC § 56(b)(1)(A)(I).

[47] See David G. Savage, *A Win-Lose Situation*, 90 A.B.A. J., 18 (Nov. 2004), discussing *Spina v. Forest Preserve District of Cook County*, 207 F. Supp.2d 764 (N.D. 2002), where client-taxpayer was awarded $300,000 but her attorneys received $1 million in fees, all of which was taxed to the client-taxpayer, leaving the taxpayer owing $99,000 more in tax liabilities than she received from the award.

[48] The assignment of income doctrine holds that one may not escape the incidence of taxes upon income earned by assigning the income to another. *Raymond v. U.S.*, 355 F.3d 107 (2nd Cir. 2004) (holding contingent fees taxable to client-taxpayer). *Baylin v. U.S.*, 43 F.3d 1451 (Fed. Cir. 1995); *Yong v. Comm'r*, 240 F.3d 368 (4th Cir. 2001).

[49] *Baylin v. U.S.*, 43 F.3d 1451 (Fed. Cir. 1995) (where partnership received award in condemnation proceeding, court held that under Maryland law attorneys' fee lien statute did not give attorney an ownership interest but merely places a charge on the funds); *Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001); *Kenseth v. Comm'r*, 259 F.3d 881 (7th Cir. 2001) (holding under Wisconsin law, that entirety of legal fee in discrimination case must be part of gross income of the owner of the fee, and attorney's lien in fee does not confer ownership interest to the attorney); *Raymond v. U.S.*, 355 F.3d 107 (2nd Cir. 2004) (where the court criticized state-by-state determination of whether attorneys' fees are income to the client and held that award is taxable to the client in its entirety); *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000) (holding that the Internal Revenue Code broadly taxes income to its owner which cannot be escaped by assignment, and the court also noted that the Alaska attorney lien provisions do not grant attorneys an ownership interest in contingent fees).

have utilized a state-specific analysis to conclude that legal fees may be excluded from a client's income if, under state law, the attorney has a lien on the fees or the taxpayer and attorney are joint owners in the lawsuit proceeds. [50] This state-by-state analysis has caused a confusing patch-work of similarly situated taxpayers being treated differently depending on where they live.[51]

Two developments will likely reduce the litigation of this issue. The Supreme Court has heard oral arguments and will decide two consolidated cases this term: *Banaitis v. Commissioner* [52] and *Banks v. Commissioner*. [53] The Court's decision should resolve the split in the Federal circuits, although a taxpayer victory could potentially result in different treatment for similarly-situated taxpayers depending on state law. Additionally, Congress passed legislation in 2004 allowing taxpayers an "above the line" deduction from gross income for attorneys' fees and court costs paid by them, or paid by another on their behalf, in connection with an allegation of unlawful discrimination.[54] The allowance of an above-the-line deduction is important because the deductions will no longer be considered "miscellaneous itemized deductions." While this provision will help taxpayers suffering unlawful discrimination, it will not help taxpayers who receive taxable awards or settlements in contingency fee nonphysical personal injury cases not alleging unlawful discrimination.

[50] *Estate of Clarks v. U.S.*, 202 F.3d 854 (6th Cir. 2000) (holding Michigan law grants attorneys a lien in contingent fees); *Foster v. U.S.*, 249 F.3d 1275 (11th Cir. 2001) (holding that post judgment interest on award was subject to Alabama lien law giving attorney ownership interest in fee and therefore, interest was excludable from income of client); *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959) (holding that Alabama law grants attorneys lien in contingent fees).

[51] *Banks v. Comm'r*, 345 F.3d at 387.

[52] *Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003), cert. granted, 124 S.Ct. 1712, 158 L.Ed.2d 398 (2004).

[53] *Banks v. Comm'r*, 345 F.3d 373 (6th Cir. 2003), cert. granted, 124 S.Ct. 1712 (2004).

[54] On October 22, 2004, the President signed into law H. R. 4520, the American Jobs Creation Act of 2004. Section 703, Civil Rights Tax Relief, provides an "above the line" deduction of attorneys' fees and court costs paid by or on behalf of taxpayers in an unlawful discrimination action.

Miscellaneous Exclusion Cases

IRC § 931 - Three cases were litigated during the review period on the issue of whether Johnston Island is a possession of the United States within the meaning of IRC § 931 and the applicable regulations.[55] IRC § 931 does not include Johnston Island as a U.S. possession for purposes of the income exclusion, but the regulation, which was issued before a change in the law in 1986, specifically lists Johnston Island as a possession. During the last several years, at least seven taxpayers relied upon the Treasury Regulations and excluded wages earned while residing on Johnston Island from gross income and litigated against the IRS position.[56] Courts have consistently ruled against the taxpayers, holding that Johnston Island is not a possession for tax purposes in post-1986 years and that the IRC provisions govern over conflicting Treasury Regulations.[57] While it is distressing when taxpayers are given obsolete guidance in the Treasury Regulations, it is even more disturbing when the IRS penalizes taxpayers for relying on the IRS' own regulations. In *Taibo v. Commissioner*, the IRS sought to impose a negligence penalty under IRC § 6662 against a taxpayer who followed Treasury Regulation 1.931-1, arguing that the taxpayer should have known that the result indicated in the Treasury Regulations was "too good to be true." However, the Tax Court disagreed, holding that although the taxpayer should be taxed on the income earned on Johnston Island, he had a reasonable basis to exclude it and relieved the taxpayer of the negligence penalty.[58]

IRC § 86 - This section determines the extent to which Social Security benefits and certain railroad retirement benefits are taxable. Several taxpayers challenged whether Social Security benefits fall within the definition of gross income, and another taxpayer unsuccessfully litigated the constitutionality of the taxation of Social Security disability benefits.[59] Only one taxpayer litigated the operational mechanics of IRC § 86.[60]

IRC Subsections 104(a)(3)-(4) and IRC § 105 - These sections exclude from gross income amounts paid through accident and health insurance plans, as well as amounts paid through pensions or annuities paid on account of accidental injuries or illness. Five cases were litigated on issues relating to these sections. Taxpayers in two cases failed to under-

[55] *Haessly v. Comm'r*, 92 A.F.T.R.2d (RIA) 5167 (9th Cir. 2003); *Hautzinger v. Comm'r*, T.C. Memo. 2003-236; *Umbach v. Comm'r*, 357 F.3d 1108 (10th Cir. 2003).

[56] *See Taibo v. Comm'r*, 2004-196, for a full description of this litigation.

[57] *Haessly v. Comm'r*, 92 A.F.T.R.2d (RIA) 5167 (9th Cir. 2003); *Hautzinger v. Comm'r*, T.C. Memo. 2003-236; *Umbach v. Comm'r*, 357 F.3d 1108 (10th Cir. 2003); *Farrell v. U.S.*, 313 F.3d 1214 (9th Cir. 2002); *Jones v. Comm'r*, T.C. Memo. 2003-14.

[58] *Taibo v. Comm'r*, T.C. Memo. 2004-196. See this report, *infra* 4 for discussion of Most Litigated Issue number 5, IRC § 6662 negligence penalties.

[59] *Laws v. Comm'r*, T.C. Summ. Op. 2003-84.

[60] *In Sharp v. Comm'r*, T.C. Summ. Op. 2004-27, where the taxpayer received a lump sum of benefits attributable to prior years, the taxpayer contested the amount of benefits includible in income. However, the Tax Court ruled that the taxpayer failed to make the necessary election to allocate the taxation of those amounts to other years.

stand the differences between disability payments and ordinary retirement payments for purposes of the exclusion from gross income.[61] In another case, *Hayden v. Commissioner*, the taxpayer was receiving disability type payments for severe neurological impairment of his body. However, the payments were not computed by reference to the nature of the disability, and therefore failed the test in IRC § 105(c)(2) that requires payments to be computed by reference to the nature of injury without regard to the period that the taxpayer is absent from work.[62] Because the taxpayer would have received the same payment regardless of the severity of disability, the Tax Court reasoned that the payments were more akin to a substitution for taxable wages than payment for loss of use of the body.[63] In the fifth case, the Tax Court held that payments to the taxpayer were legitimate reimbursements for medical expenses pursuant to a plan and were therefore excludable from gross income.[64]

Seven cases were also litigated in a smaller third category which addressed the issue of to whom income is taxable.[65] The result in *Gilmore v. Commissione*r stood out as inequitable.[66] The taxpayer, who had been through divorce proceedings in the tax year in question, received a military retirement pension, which can either be divided in a state court divorce proceeding or remain the property of the retiree.[67] Because the Colorado state court provided for direct payments to the taxpayer's wife rather than dividing the retirement benefit, the Tax Court held that the taxpayer remained the sole owner of the retirement account, even though payments from the account went to the spouse.[68] The Tax Court further held that the payments to the spouse did not constitute deductible alimony because the Colorado court's order provided that the support payments would not be affected by the recipient's marriage or death.[69] The *Gilmore* decision is a reminder of both

[61] In *Jeanmarie v. Comm'r*, T.C. Memo. 2003-337, the taxpayer unsuccessfully argued that Civil Service Retirement income falls within IRC § 104(a)(4). Likewise, in *Enloe v. Comm'r*, T.C. Summ. Op. 2003-81, the Tax Court ruled that the payments were from ordinary pension plan and not related to disability.

[62] *Hayden v. Comm'r*, T.C. Memo. 2003-184.

[63] *Id.*

[64] *Waterfall Farms v. Comm'r*, T.C. Memo. 2003-327.

[65] *Bland v. Comm'r*, T.C. Summ. Op. 2003-172 (holding testimony substantiated taxpayer's position that she was merely conduit for the person who actually earned money); *Gilmore v. Comm'r*, T.C. Summ. Op. 2004-50 (holding that military retirement was not properly divided and is still taxable to husband-taxpayer) *Kerr v. Comm'r*, T.C. Memo. 2003-311 (holding evidence did not support that taxpayer returned checks to third party for whom work was performed); *Pfister v. Comm'r*, 359 F.3d 352 (4th Cir. 2004) (holding military retirement was divided and equally taxable between taxpayer and husband); *Stevens v. Comm'r*, T.C. Summ. Op. 2003-163 (holding death does not excuse decedent from paying taxes); *Walker v. Comm'r*, T.C. Summ. Op. 2003-335 (holding capital gain is taxable to the owner and informal agreement between husband and wife did not shift incidence of tax); *Schwemmer v. Comm'r*, T.C. Summ. Op. 2003-139 (holding trust was a sham and did not shift income obligation from taxpayer).

[66] *Gilmore v. Comm'r*, T.C. Summ. Op. 2004-50

[67] 10 U.S.C. § 1408(c)(1).

[68] *Id.*

[69] IRC § 71(b)(1)(D) provides that a payment will not be treated as deductible alimony if the payments terminate at the death of the recipient spouse.

the complexity of our tax system and how similarly situated litigants can receive different tax results depending on their treatment in a state court divorce proceeding.

PRO SE AND REPRESENTED TAXPAYERS

Sixty-three of the cases, or 62 percent, were litigated without benefit of counsel, *pro se*. Table 3.2.1 below shows a comparison of *pro se* cases to the total population of income issue cases analyzed. Interestingly, taxpayers who were unrepresented prevailed at the same rate as taxpayers who were represented.

TABLE 3.2.1, ANALYSIS OF *PRO SE* INCOME CASES

Type of Taxpayer	Number of Cases	Pro Se		Represented		Split Decision
		Decision for Taxpayer	Decision for IRS	Decision for Taxpayer	Decision for IRS	
Individual	87	3	50	0	26	8
Businesses	15[70]	0	8	2	4	1
Total	102	3	58	2	30	9

CONCLUSION

All of the cases reviewed in this analysis related to income that taxpayers failed to report. Taxpayers prevailed, in whole or in part, in only 14 out of 102 cases. While no clear patterns are evidenced, taxpayers appeared to have the most difficulty in cases where other Internal Revenue Code sections exclude income items that would otherwise be taxable.

Taxpayers and their representatives continue to litigate IRC § 104(a)(2) cases involving damages attributable to physical injuries. The confusion appears in part due to the fact that amendments to the statute after the SBJPA exclude damages attributable only to *physical* personal injuries. Consistent with the legislative history of the SBJPA, courts have been interpreting IRC § 104(a)(2) amendments to exclude damages attributable to emotional distress, even where the symptoms (nausea, sleeplessness and stomach problems) are *physical* in nature.[71] The Treasury Regulations have not yet been amended to conform to the SBJPA, and this may contribute to the confusion among taxpayers and practitioners.

[70] Two cases involving estates and business conducted by decedents are counted in business category.

[71] For discussion of legislative history of SBJPA, *see Henderson v. Comm'r*, T.C. Memo. 2003-168.

Additionally, taxpayers continue to litigate the issue of whether contingent attorneys' fees in nonphysical personal injury cases are taxable to the client-taxpayer. It is uncertain how the Supreme Court's opinion in the consolidated *Banks* and *Banaitis* cases will impact future litigation in this area. In many of these cases, the interaction of the AMT with the miscellaneous deduction for attorney fees often creates inequitable results and leads taxpayers to challenge the operation of the law. While Congress recently addressed this problem for cases involving unlawful discrimination, the inequity remains for the subset of cases that do not involve discrimination.

Outdated Treasury Regulations also caused confusion for taxpayers who worked on Johnston Island. Treasury Regulation 1.931-1 provides that Johnston Island is a possession of the United States for purposes of IRC § 931, thereby excluding wages earned there from income. However, IRC § 931 does not list Johnston Island as a possession. At least seven taxpayers relied upon the Treasury Regulations and ended up in litigation with the IRS. This is another instance where the Treasury Regulations need to be amended. The tax code is sufficiently complicated without having conflict between the statutes and the interpreting regulations.

LITIGATED ISSUE #3 MOST LITIGATED ISSUE: TRADE OR BUSINESS EXPENSES

SUMMARY

Trade or business expense is perennially one of the ten most litigated tax issues in the Federal courts. Between June 1, 2003, and May 31, 2004, 68 cases that included trade or business expense issues were litigated. The courts affirmed the IRS position in nearly 75 percent of the cases, while taxpayers prevailed just seven percent of the time. The remaining cases resulted in split decisions.

Substantiation of trade or business expenses was the primary sub-issue litigated by taxpayers. Taxpayers often failed to provide sufficient documentation of expenses they incurred, causing them to lose otherwise valid deductions. In other cases, the IRS challenged whether the taxpayer was engaged in a trade or business with the primary purpose of making a profit. A common issue litigated by business entities involved the deductibility of capital expenditures.

PRESENT LAW

Internal Revenue Code § 162 is one of the Code's most fundamental provisions, allowing deductions for ordinary and necessary trade or business expenses paid or incurred during the taxable year. Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance. The IRS, the Department of Treasury, Congress, and the courts continue to provide legal guidelines about whether a taxpayer is entitled to certain trade or business deductions. The litigated cases analyzed for this report reveal that this process is ongoing. When a taxpayer seeks judicial review of the IRS' determination of tax liability, the courts must often address a series of questions, including those discussed below, before issuing decisions.

What constitutes a trade or business for purposes of IRC § 162?

Although "trade or business" is one of the most widely used terms in the Internal Revenue Code, no definition can be found in the Code or in any Treasury Regulation.[1] The definition of "trade or business" comes from the common law of Federal income tax, where concepts have been developed and refined by court decisions.[2]

What is an ordinary and necessary expense?

Ordinary and necessary expenses are current business expenses that are paid or incurred during the taxable year. A current business expense must be both ordinary and necessary in relation to the taxpayer's trade or business.[3] In *Welch v. Helvering*,[4] the Supreme Court

[1] The term "trade or business" appeared in at least 492 subsections of the Code and 664 provisions of the Treasury Regulations. F. Ladson Boyle, *What Is a Trade or Business?* 39 Tax Law. 737 (Summer 1986).

[2] Carol Duane Olson, *Toward a Neutral Definition of "Trade or Business" in the Internal Revenue Code*, 54 U. Cin. L. Rev. 1199 (1986).

[3] IRC § 162(a).

[4] 290 U.S. 111 (1933).

stated that the words "ordinary" and "necessary" have difference in meaning, and both must be satisfied for a taxpayer to benefit from the deduction. In *Deputy v. Du Pont*,[5] the Supreme Court described an "ordinary" expense as customary or usual and of common occurrence in the taxpayer's business. A "necessary" expense is described as appropriate and helpful for development of the business.

The courts have held that the amount of the expense must be reasonable as well as ordinary and necessary. In *Commissioner v. Lincoln Elec. Co.*,[6] the Court of Appeals for the Sixth Circuit held that "...the element of reasonableness is inherent in the phrase 'ordinary and necessary.' Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount."[7]

Is the expense a currently deductible expense or a capital expenditure?

A currently deductible expense is an ordinary and necessary expense that is paid or incurred during the taxable year in the course of carrying on a trade or business.[8] No deductions are allowed for the cost of acquisition, construction, improvement, or restoration of an asset that is expected to last more than one year.[9] Instead, capital expenditures may be subject to amortization, depletion, or depreciation over the useful life of the property.[10]

Determining whether expenditures are deductible under IRC § 162(a) or must be capitalized under IRC § 263 is a question of fact. Courts have adopted a case-by-case approach in applying principles of capitalization and deductibility.[11]

Can the taxpayer substantiate that the expense was paid or incurred during the taxable year?

Present law requires a taxpayer to maintain books and records that substantiate income, deductions, and credits,[12] including adequate records to substantiate deductions claimed as trade or business expenses.[13] If a taxpayer is unable to substantiate deductions by documentary evidence (e.g., invoice, paid bill, or canceled check) but can establish that he or she had some deductible business expenditures, the courts may opt to employ the *Cohan* rule to grant the taxpayer a reasonable amount of deductions.

[5] 308 U.S. 488 (1940).

[6] 176 F.2d 815 (6th Cir. 1949).

[7] *Comm'r v. Lincoln Elec. Co.*, 176 F.2d 815, 817 (6th Cir. 1949) (citation omitted).

[8] IRC § 162(a).

[9] *See INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992).

[10] IRC § 167.

[11] *See PNC Bancorp, Inc. v. Comm'r*, 212 F.3d 822 (3rd Cir. 2000); *Norwest Corp. v. Comm'r*, 108 T.C. 265 (1997).

[12] IRC § 6001; Treas. Reg. § 1.6001-1; Treas. Reg. § 1.446-1(a)(4).

[13] IRC § 6001; Treas. Reg. § 1.6001-1.

The *Cohan* rule is a rule of "indulgence" established by the United States Court of Appeals for the Second Circuit in its decision in *Cohan v. Commissioner*.[14] The Court of Appeals held "...the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent."[15]

The *Cohan* rule may not be utilized in situations where IRC § 274(d) applies. This section provides that unless a taxpayer complies with strict substantiation rules, no deduction is allowable for (1) traveling expenses, (2) entertainment expenses, (3) gifts, or (4) certain "listed property."[16] A taxpayer is required to substantiate a claimed IRC § 274(d) expense with adequate records or sufficient evidence corroborating the taxpayer's statement establishing the amount, time, place, and business purpose of the expense.[17]

Who has the burden of proof in a substantiation case?

Generally, the burden is on the taxpayer to show that the proposed determination made by the Commissioner of Internal Revenue is incorrect. However, if, in any court proceeding, a taxpayer introduces credible evidence with respect to his income tax liability, the burden may shift to the Commissioner.[18]

ANALYSIS OF LITIGATED CASES

Trade or business expenses have been identified as one of the ten most litigated issues by taxpayers since the first edition of the National Taxpayer Advocate's *Annual Report to Congress* in 1998.[19] Sixty-eight cases involving various trade or business expense issues were litigated in the Federal court system during the period June 1, 2003, through May 31, 2004. Table 3 in Appendix 2 contains a detailed listing of the cases.

Table 3.3.1 categorizes the significant trade or business expense issues raised by taxpayers. Cases involving multiple issues are included in more than one category. In *Kwan v. Commissioner*,[20] for example, three distinct trade or business expense issues were raised, so the case can be found in three categories in the table.

[14] 39 F.2d 540 (2nd Cir. 1930).

[15] *Cohan v. Comm'r*, 39 F.2d 540, 544 (2nd Cir. 1930).

[16] "Listed property" means any property that can be used for personal purposes, including any property used as a means of transportation, any property of a type generally used for purposes of entertainment, recreation, or amusement, any computer or peripheral equipment, etc. IRC § 280F (d)(4)(A)(ii), (iii), and (iv).

[17] Treas. Reg. § 1.274-5T(b).

[18] IRC § 7491(a)(1) applies to a court proceeding in which the examination started after July 22, 1998, and if there is no examination, to the taxable period or events which started or occurred after July 22, 1998.

[19] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104, (Revisions 12-1998 - 12-2003).

[20] T.C. Summ. Op. 2003-119.

TABLE 3.3.1, TRADE OR BUSINESS EXPENSE CASES & ISSUES

Issue	Type Of Taxpayer	
	Sole Proprietor	Business Entity
Ordinary and Necessary Trade or Business Expenses (IRC § 162)	13	12
Substantiation of Expenses (IRC §§ 274 and 6001)	27	4
Expense vs. Capital Expenditure (IRC §§ 162(a) vs. 263(a))	3	4
Expenses Subject to Limitation under IRC §§ 280A and 280F	14	1
Expense Election under IRC § 179	3	0
Profit Objective (IRC § 183)	7	1
Start-up Expenses (IRC § 195)	1	0

COURT DECISIONS

Table 3.3.2 reflects the disposition of court decisions in each category of cases.

TABLE 3.3.2, TRADE OR BUSINESS EXPENSE COURT DECISIONS

Type of Taxpayer	IRS	Taxpayer	Split	Total
Sole Proprietors	44	1	4	49
Business Entities	6	4	9	19
Totals	50	5	13	68

Sole Proprietors

Forty-nine of the 68 cases analyzed were litigated by taxpayers with sole proprietorships. Of these, 40 (82 percent) involved *pro se* taxpayers, those who had no legal representation. The IRS prevailed in 90 percent of *pro se* cases involving sole proprietors, which is consistent with the IRS' winning percentage among all sole proprietor cases.

TABLE 3.3.3, TYPE OF REPRESENTATION (SOLE PROPRIETORS)

	IRS	Taxpayer	Split	Total
Pro Se	36	1	3	40
Represented by Counsel	8	0	1	9
Totals	44	1	4	49

The trade or business expense issue litigated most by sole proprietors involved the substantiation of expenditures. In many instances, taxpayers claimed trade or business deductions without adequately documenting those expenses with contemporaneous record-keeping. For example, in *Rouse v. Commissioner*,[21] the *pro se* taxpayers (husband and wife) claimed a Schedule C deduction for car and truck expenses of $2,200. For passenger automobiles and other "listed property,"[22] the taxpayer is required to substantiate the amount, time, and business purpose of the transportation expense.[23] Because the taxpayers merely estimated the amount of car and truck expenses after the mileage was incurred, the court disallowed the deduction for lack of substantiation.

In *Jones v. Commissioner*,[24] the *pro se* taxpayer was employed as both a firefighter and a police officer and claimed over $2,000 in uniform and dry cleaning expenses. While the taxpayer admitted that he was "not the world's best record-keeper," he testified credibly with respect to these items and their business purpose. The Tax Court accepted the testimony and estimated the amount of deductible expenses based on the *Cohan rule*. Note that the *Cohan rule* was available because the strict substantiation requirements of IRC section 274(d) do not apply to uniform and dry cleaning expenses.

Another common trade or business issue litigated by sole proprietors relates to whether an activity had a profit objective. To be considered a bona fide trade or business, an activity must be conducted with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity must be for income or profit. The test for whether a taxpayer conducted an activity for profit is whether he or she entered into or continued the activity with an actual or honest objective of making a profit.[25]

In *Guadagno v. Commissioner*,[26] the *pro se* taxpayers (husband and wife) were Amway product distributors who, prior to their experience with Amway, had no experience running a business. The taxpayers did not solicit or receive independent business advice during the course of their affiliation with Amway. During the years in issue, the taxpayers spent minimal time and effort attempting to sell Amway products but instead focused on recruiting other potential distributors. In denying the net losses claimed for the three years in question, the Tax Court considered the expertise of the taxpayers and their associates, the history of income or losses, and elements of personal pleasure or recreation, among others. The court determined that taxpayers' primary purpose for engaging in the distribution of Amway products was not for income or profit, and disallowed the deductions.

[21] T.C. Summ. Op. 2004-49.

[22] IRC § 280F(d)(4).

[23] IRC § 274(d); Treas. Reg. § 1.274-5T.

[24] T.C. Summ. Op. 2004-76.

[25] IRC § 183; Treas. Reg. § 1.183-2(a).

[26] T.C. Summ. Op. 2003-88.

Business Entities

Nineteen of the 68 trade or business expense cases tried in Federal courts involved business entities, which had significantly greater success than sole proprietors in receiving a favorable outcome. Taxpayers received full or partial relief from the courts in approximately two-thirds of the business entity cases (13 out of 19), compared to only ten percent in sole proprietor cases. This success rate may be explained in part by the fact that most business entities are represented in court by attorneys, whereas most sole proprietors represent themselves.

A common issue litigated by business entities is that of currently deductible expenses versus capital expenditures. The cost of incidental repairs to property is deductible if those repairs neither materially add to the value of the property nor appreciably prolong its life.[27] However, if the expenditure is for permanent improvements that increase the value or appreciably prolong the life of property, it must generally by capitalized and depreciated.[28]

In *Northen v. Commissioner*,[29] the *pro se* taxpayer owned an interest in a commercial building that had a leaking roof. The roof was intact except in one spot, but the roofing company's policy was to remove and replace all the tar and gravel down to the plywood in the roof and spray the entire roof with protective foam. The Tax Court observed that the taxpayer's sole purpose in having the work done was to prevent further leakage, not to prolong the life of the property or increase its value. Thus, the taxpayer was entitled to a current deduction for the expenditure.

As discussed previously, the burden is generally on the taxpayer to show that the proposed determination by the IRS is incorrect. However, if a taxpayer introduces credible evidence with respect to his tax liability, the burden may shift to the Commissioner.[30] This mere shift in presumption can make all the difference.

In *Griffin v. Commissioner*,[31] the taxpayers paid property taxes on behalf of their partnership's real estate. The IRS denied their claimed deduction and instead treated the tax payments as capital contributions to the partnership. The Tax Court initially held that the taxpayers failed to introduce credible evidence that they were engaged in their individual capacities in a trade or business for which the tax payments would have represented ordinary and necessary expenses. However, the Court of Appeals for the Eighth Circuit[32]

[27] Treas. Reg. § 1.162-4.

[28] See IRC §§ 167 and 263(a).

[29] T.C. Summ. Op. 2003-113.

[30] IRC § 7491(a)(1).

[31] T.C. Memo. 2002-6.

[32] *Griffin v. Comm'r*, 315 F.3d 1017 (8th Cir. 2003).

determined that the taxpayers' testimony was credible and sufficient to place the burden of proof on the Commissioner. On remand, the Tax Court determined that the Commissioner failed to sustain his burden of proof in offering contrary evidence, and allowed the deduction.[33]

Tax Court Small Case Procedure

Twenty-seven of the 68 (40 percent) trade or business expense cases were filed electing the small case procedure[34] in the U.S. Tax Court. In such cases, taxpayers received full or partial relief less than 20 percent of the time. By contrast, taxpayers received some sort of relief in nearly 30 percent of the non-small cases, which may be a result of these taxpayers having representation in more instances.

TABLE 3.3.4, COMPARISON OF DECISIONS BY TYPE OF CASE

	IRS	Taxpayer	Split	Total
Small Case	22	1	4	27
Non-Small Case	29	4	8	41
Totals	51	5	12	68

CONCLUSION

Taxpayers continue to challenge the IRS with regard to trade or business expense deductions, and represented taxpayers fare much better than their *pro se* counterparts. While the IRS generally prevails, the courts do not always favor the IRS interpretation of the law. This is an indication that the definition of an allowable trade or business expense is open to interpretation. Sometimes, the allowance or disallowance of a deduction hinges on which party has the burden of proof.

Many of the cases demonstrated taxpayer confusion over legal requirements. The IRS can assist these taxpayers, and minimize litigation, by continuing to provide clear guidance on the deductibility of trade or business expenses. Through education, outreach, and partnering with stakeholders, the IRS can help taxpayers understand what trade or business deductions are allowable and how they must substantiate those expenses. The IRS should continue to reach out proactively to taxpayers about this issue, particularly sole proprietors. By helping taxpayers understand the legal requirements, the IRS will encourage taxpayers to comply with their tax obligations and minimize the risk of litigation.

MOST LITIGATED TAX ISSUES

[33] *Griffin v. Comm'r,* T.C. Memo. 2004-64.

[34] *See* IRC § 7463. The term "small case" means a case in which the amount in dispute is $50,000 or less and in which the Court has concurred with the taxpayer's election. Tax Court Rules of Practice and Procedure, Rule 170. Trials conducted under the small case procedure are conducted as informally as possible with all probative evidence being admitted. Tax Court Rules of Practice and Procedure, Rule 174(b). There is no right to appeal the decision of the Tax Court in a case conducted under the small tax case procedures. IRC § 7463(b).

MOST LITIGATED

MOST LITIGATED TAX ISSUES

LITIGATED

ISSUE #4

MOST LITIGATED ISSUE: JOINT AND SEVERAL LIABILITY

SUMMARY

When filing an income tax return, married individuals may elect to file jointly or separately. If they file a joint return, both spouses are held jointly and severally liable for any deficiency or tax due.[1] The IRS can then choose to collect tax shown on the return as well as from either taxpayer.

Enacted in 1998, IRC § 6015 provides relief from joint and several liability in a limited number of circumstances.[2] The Code provides three avenues for relief, allowing a taxpayer to request relief from joint and several liability if certain requirements are met. From June 1, 2003, through May 31, 2004, 62 opinions involving IRC § 6015 were issued in the Federal court system.

PRESENT LAW

Election Under IRC § 6015(b)

Similar to the repealed IRC § 6013(e), IRC § 6015(b) provides the traditional type of relief from joint and several liability. To be eligible for an election under IRC § 6015(b), a taxpayer must demonstrate that:

1) a joint return was filed;
2) the understatement of tax is attributable to erroneous items of the nonrequesting spouse;
3) the requesting spouse, upon signing the return, did not know or have reason to know of the understatement;
4) taking into account all of the facts and circumstances, it is inequitable to hold the requesting spouse liable; and
5) the requesting spouse has made an election within two years after the IRS has begun collection activities with respect to the requesting spouse.[3]

Separate Liability Under IRC § 6015(c)

A taxpayer may also make an election under IRC § 6015(c). This election separates the deficiency arising under the joint return and allocates to each joint filer that portion of

[1] IRC § 6013(d)(3).

[2] The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105 - 206, 112 Stat. 685. Section 6015 replaced former IRC § 6013(e) which provided limited relief from joint and several liability.

[3] Frequently, the first collection activity against a taxpayer occurs when a tax refund is offset against an outstanding liability under IRC § 6402(a). *See Campbell v. Comm'r*, 121 T.C. 89 (2003). Other examples of collection activity include a IRC § 6330 notice and the filing of a suit by the United States against a taxpayer IRS for collection. Collection activity does not include a notice of deficiency, the filing of a Notice of Federal Tax Lien, or a demand for payment of tax. Treas. Reg. §1.6015-5(b)(2)(i).

the deficiency attributable to him or her as calculated under the provisions of IRC § 6015(d). The requesting spouse must specify those items on the return that are attributable to the other spouse and from which the requesting spouse is seeking relief. At the time the election is made, the taxpayer must either be no longer married to or legally separated from the nonrequesting spouse, or the taxpayer must not have been a member of the same household as the nonrequesting spouse for the 12 month period immediately preceding the election.[4]

A taxpayer is ineligible to make an election under IRC § 6015(c) if the IRS demonstrates that an individual had "actual knowledge," at the time the return was signed, of any item giving rise to a deficiency which was not allocable to such individual.[5] Finally, IRC § 6015(c) includes the same two-year statute of limitations found in IRC § 6015(b). This requires the taxpayer to make the election within the two years of the first collection action.

Equitable Relief Under IRC § 6015(f)

Taxpayers who are not eligible for relief under IRC § 6015(b) or (c) may be eligible for equitable relief under IRC § 6015(f) if, taking into account all of the facts and circumstances, it would be inequitable to hold the requesting spouse liable for any unpaid tax or deficiency.[6] Rev. Proc 2003-61 establishes the procedure for obtaining equitable relief under IRC § 6015(f).[7] Relief under IRC § 6015(b) or (c) is only available for understatements of tax. Relief under IRC § 6015(f) is available for underpayments as well as understatements of tax.

Judicial Review Under IRC § 6015(e)

The taxpayer may petition the United States Tax Court for review if the request for relief is denied (either entirely or in part). The taxpayer has 90 days from the date the IRS mails the Notice of Determination to request judicial review.[8] If no determination is received from the IRS within six months after the filing of Form 8857, Request for Innocent Spouse Relief, the taxpayer may petition the Tax Court at any time after the six month period has expired.[9]

[4] IRC § 6015(c)(3)(A)(i).

[5] IRC § 6015(c)(3)(C).

[6] IRC § 6015(f).

[7] Rev. Proc. 2003-61, 2003-32 I.R.B. 296, superseding Rev. Proc. 2000-15, 2000-1 C.B. 447.

[8] IRC § 6015(e)(1)(A)(i)(I).

[9] IRC § 6015(e)(1)(A)(i)(II). A taxpayer who requests a hearing pursuant to IRC §§ 6320 or 6330 may also raise spousal defenses. IRC § 6320(c); § 6330(c)(2)(A)(i).

ANALYSIS OF LITIGATED CASES

There were 62 IRC § 6015 cases decided in the Federal courts between June 1, 2003, and May 31, 2004.[10] Of those cases, 56 were decided in the United States Tax Court, three were decided in the United States Courts of Appeals,[11] and three were decided in the United States district courts.[12] Of the 62 cases, 36 were litigated *pro se*, or without the assistance of legal representation. Forty-six of the 62 cases were decided in favor of the IRS, 12 in favor of the taxpayer, and four resulted in split decisions. A detailed listing of the decided cases, and their individual issues, can be found in Table 4 in Appendix 2 of this report. A brief discussion of some of the most significant cases follows.

Ewing v. Commissioner

One of the most important IRC § 6015 cases decided this year is *Ewing v. Commissioner*,[13] which is notable for the procedural issue it addressed. In a reviewed opinion,[14] the United States Tax Court decided by a vote of 13 to four that in determining a petitioner's request for relief under IRC § 6015(f), it could consider evidence introduced at trial which was not included in the administrative record.[15]

The respondent argued that in cases applying an abuse of discretion standard, the court may consider only evidence contained in the administrative record in rendering its decision. The respondent further argued that the court should not make a determination *de novo* when the standard of review is abuse of discretion; however, the court noted that this was at odds with Tax Court practice and procedure. The court further noted that

[10] For a detailed breakdown of the decided cases, see Table 4 in Appendix 2.

[11] *Maier v. Comm'r,* 360 F.3d 361 (2nd Cir. 2003) (upholding dismissal of petition for review on the grounds that petitioner is a non-electing spouse and the court lacked jurisdiction to consider petitioner's claim); *Jonson v. Comm'r*, 353 F.3d 1181 (10th Cir. 2003) (affirming Tax Court's decision not to grant relief under IRC § 6015(c) because once petitioner died, there was no individual to whom IRC § 6015(c) could apply); *Kanter, Estate of v. Comm'r*, 337 F.3d 833 (7th Cir. 2003) (affirming Tax Court's decision not to decide whether petitioner participated meaningfully in the current litigation).

[12] *Cannon v. U.S.*, 322 F.Supp.2d 636 (W.D. Pa. 2004) (holding that petitioner's claims are barred by the statute of limitations); *Jones v. U.S.*, 322 F.Supp.2d 1025 (D. N.D. 2004) (holding petitioner is entitled to relief under IRC § 6015(b)); *Favret v. U.S.*, 92 A.F.T.R.2d 7249 (E.D. La. 2003) (holding that since petitioner was entitled to relief under IRC § 6015(f), she was also entitled to a refund stemming from taxpayer's 1998 refund being applied to her 1991 outstanding liability);

[13] *Ewing v. Comm'r.*, 122 T.C. 32 (2004), *appeal docketed*, Nos. 04-73237, 04-73699 (9th Cir. June 16, 2004) (Ewing II). Two jurisdictional issues were considered in *Ewing v. Comm'r.*, 118 T.C. 31 (2002) (*Ewing I*). Both parties have appealed the decision in *Ewing II.*

[14] The Tax Court is composed of 19 judges and is currently divided into 19 divisions of one member each. IRC §§ 7443(a); 7444(c). Each division of the Tax Court (i.e., each judge) hears cases as directed by the chief judge and makes a report of the determination on the cases tried. The report shall become the opinion of the Tax Court within 30 days unless the chief judge directs that it be reviewed by the full Tax Court (IRC § 7460(b)), in which case, the report will be issued as an officially reported "reviewed by the Court" opinion. The reports not reviewed by the full Tax Court may be issued as published opinions or memorandum opinions.

[15] When her spouse did not pay the amount reported on their joint return, the petitioner sought relief under IRC § 6015(f); at the administrative level she did not submit all relevant evidence and was denied relief from joint and several liability. During the administrative process, petitioner was represented by two enrolled agents.

applying an abuse of discretion standard affects the standard of review; it does not restrict what evidence the court can consider in making its decision.

Ultimately, the court announced that it was performing a *de novo* review, applying an abuse of discretion standard, of the petitioner's request for relief. This trial *de novo* is not limited to the information contained in the administrative record, but allows consideration of evidence presented at trial as well.[16]

Hopkins v. Commissioner

In *Hopkins v. Commissioner*,[17] the Tax Court dealt with the question of finality of a closing agreement that was signed before the effective date of IRC § 6015. The petitioner and her husband had liabilities stemming from erroneous partnership deductions and a casualty loss. During the course of an examination, the couple entered into a closing agreement with the IRS.[18] Subsequently, the petitioner filed a request for relief from joint and several liability in reference to the same liabilities that were the subject of the closing agreement and remained unpaid as of July 22, 1998.[19] The IRS claimed that the closing agreement precluded the petitioner from later seeking relief under IRC § 6015.

In general, a closing agreement settles or closes the liability of an individual with regard to specific tax years, thus preventing the taxpayer from later disputing the tax that was the subject of the agreement.[20] The closing agreement did not contain any provision preserving the petitioner's right to request relief from joint and several liability, so the taxpayer would generally be barred from belatedly raising an innocent spouse defense.

The court held that the petitioner did not have an opportunity to raise a claim for relief under IRC § 6015 because it was not enacted at the time the closing agreement was entered into and petitioner should not be precluded from raising it now. This opinion has very limited effect, applying only to cases in which taxpayers entered into closing agreements prior to July 22, 1998. Closing agreements entered into on or after July 22, 1998, would generally preclude a taxpayer from subsequently raising innocent spouse relief.

[16] After evaluating the relevant case law and factors set forth in Revenue Procedure 2000-15, the Tax Court went on to hold that the Service had abused its discretion when it determined that the petitioner was not entitled to relief under IRC § 6015(f). The Tax Court found that the petitioner would suffer economic hardship if forced to pay the outstanding liability of $6,220 for the 1995 year. *Ewing v. Comm.*, 122 T.C. 32 (2004).

[17] 120 T.C. 451 (2003).

[18] Petitioner and her husband signed a Form 906, Closing Agreement on Final Determination Covering Specific Matters.

[19] RRA 98, § 3201(g)(1).

[20] IRC § 7121(b); Treas. Reg. § 301.7121-1(c).

Thurner v. Commissioner

In *Thurner v. Commissioner*[21] the petitioners each requested relief from joint and several liability. Their outstanding liabilities arose from deficiencies that had previously been the subject of collection litigation in district court. The Commissioner filed a motion for summary judgment claiming petitioners' claims were barred under *res judicata* because they could have raised an innocent spouse defense in the prior collection action.[22]

Under IRC § 6015(g)(2), once the decision of a court regarding the same taxable year at issue becomes final, it is deemed conclusive unless it is determined that the individual did not participate meaningfully in the prior proceeding. In the Tax Court litigation, Mr. Thurner filed an affidavit attesting that he handled the prior litigation entirely on his own, and Mrs. Thurner's only involvement was to sign court documents when he directed her to do so.

Based on Mr. Thurner's affidavit, the Tax Court found he participated meaningfully in the district court collection action and granted summary judgment in favor of the Commissioner based on *res judicata*. In the case of Mrs. Thurner, however, the court found insufficient facts to determine whether she had been a meaningful participant in the prior collection action. The court denied summary judgment in her case, requiring further proceedings.

Additionally, the petitioners argued that *res judicata* principles do not apply to IRC § 6015(f) cases. The court dismissed this argument, noting that IRC § 6015(f) is a "subordinate and ancillary" claim for relief which is available to taxpayer that do not meet the requirements of IRC §§ 6015(b) or (c). Claims under IRC § 6015(f) are secondary and are subject to the same *res judicata* principles as sections 6015(b) and (c).

CONCLUSION

Since its enactment in 1998, joint and several liability continues to be one of the most litigated issues in the Internal Revenue Code. Unlike many other litigated issues, however, it does not appear to be affected by legal representation, of the 62 opinions issued from June 1, 2003, through May 31, 2004, 12 cases were decided in favor of the taxpayer and four resulted in split decisions. Of the taxpayers who prevailed, just over half (seven of the 12) did so without representation, while half of the split decisions also came in cases

[21] 121 T.C. 43 (2003), *appeal docketed*, No. 03-3859 (7th Cir. Oct. 23, 2003), *appeal dismissed*, 93 A.F.T.R.2d 2004-2853 (Fed. Cir. 2004).

[22] The judicial doctrine of *res judicata* provides that the parties are bound by every matter that was decided or could have been decided in a prior court hearing. *Comm'r. v. Sunnen*, 333 U.S. 591, 597 (1948).

where the taxpayer was unrepresented (*pro se*). This may have no significance, or it may indicate that the facts-and-circumstances and equitable nature of IRC § 6015 creates opportunities and problems for both taxpayers and their representatives. Whether representation is an indicator of a taxpayer's success may be revealed as this issue continues to be litigated.

MOST LITIGATED

MOST LITIGATED TAX ISSUES

LITIGATED ISSUE #5

MOST LITIGATED ISSUE: NEGLIGENCE PENALTY, IRC § 6662(b)(1)

SUMMARY

Fifty-four cases involving the accuracy-related penalty for negligence or disregard of rules or regulations under IRC § 6662(b)(1) were litigated during the 12 months covered by our analysis. While IRC § 6662(b) provides an accuracy-related penalty for other conduct as well,[1] only the negligence penalty is described in this analysis because of the number of cases in which the negligence penalty was litigated.

PRESENT LAW

Internal Revenue Code § 6662(a) provides for the imposition of an accuracy-related penalty for the underpayment of tax which is attributable to certain causes, including negligence or disregard of the rules and regulations. The enactment of IRC § 6662 was designed to promote voluntary compliance, in part, by encouraging the accuracy of tax return information.[2] When examining a tax return, the IRS considers whether civil penalties related to accuracy should be assessed. The accuracy-related penalty applies to underpayments which are attributable to negligence or disregard of rules or regulations.[3]

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the tax laws, exercise ordinary and reasonable care in the preparation of a tax return, keep adequate books and records, or substantiate items properly.[4] Disregard of rules or regulations includes any careless, reckless or intentional disregard of those regulations.[5] Treasury Regulations provide that the following are strong indicators of negligence:

- Failure to report income shown on an information return;[6]
- Failure to make a reasonable inquiry into the correctness of a deduction, credit or exclusion on a tax return that seems "too good to be true" under the circumstances; [7] and

[1] IRC § 6662(b) lists the causes for which the accuracy-related penalty can be assessed:

(b) Portion of underpayment to which section applies. This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) *Negligence or disregard of rules or regulations*.

(2) Any substantial understatement of income tax.

(3) Any substantial valuation misstatement under chapter 1.

(4) Any substantial overstatement of pension liabilities.

(5) Any substantial estate or gift tax valuation understatement. [emphasis added]

[2] *Report on Civil Tax Penalties, Executive Task Force*, Commissioner's Penalty Study, Internal Revenue Service, note 22, pt. I, at 1 (1989).

[3] IRC § 6662(a).

[4] Treas. Reg. § 1.6662-3(b)(1).

[5] IRC § 6662(c); Treas. Reg. § 1.6662-3(b)(2).

[6] Treas. Reg. § 1.6662-3(b)(1)(i).

[7] Treas. Reg. § 1.6662-3(b)(1)(ii).

- Individual returns of partners or S corporation shareholders that are clearly inconsistent with the returns of the partnership or S corporation.[8]

The Internal Revenue Manual provides guidelines for IRS examiners to consider in assessing the negligence penalty.[9]

The accuracy-related penalty for negligence or disregard of rules or regulations is 20 percent of the underpaid tax required to be shown on the taxpayer's return.[10] The penalty does not apply if the taxpayer has reasonable cause for the error and acted in good faith, *e.g.* if an error was due to an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances.[11] The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. The most important factor is the extent of the taxpayer's effort to assess his or her proper tax liability.[12] The reasonable cause analysis is subjective and operates, in effect, to hold knowledgeable tax professionals to a higher standard of care than other taxpayers.[13]

ANALYSIS OF LITIGATED CASES

Fifty-four cases involving the accuracy-related penalty for negligence or disregard of rules or regulations were litigated in the Federal court systems from June 1, 2003 through May 31, 2004. A detailed listing of the cases may be found in Table 5 in Appendix 2. Thirty-two cases involved business tax returns and the remaining 22 cases involved individual returns. The business returns included six corporations filing Form 1120 (U.S. Corporation Income Tax Return), 22 self-employed taxpayers filing Schedule C, Profit or Loss from Business, and one taxpayer filing Schedule F, Profit or Loss from Farming. Three cases involved self-employed taxpayers who also reported rental income on Schedule E, Supplemental Income and Loss.

[8] Treas. Reg. § 1.6662-3(b)(1)(iii) and (iv).

[9] Internal Revenue Manual 20.1.5.7.1. provides that the following are indicators of negligence:

Unreported or understated income; significantly overstated deductions or credits; careless, improper, or exaggerated deductions; misrepresenting or miscategorizing deductions in such a way as to conceal their true nature; unexplainable items; inadequately kept books and records; cooperative state programs and state reports showing a negligence penalty (taking into account other factors and not relying entirely on the findings of another taxing agency); substantial errors on an issue that had been adjusted in a prior year; and providing one's return preparer with incorrect or incomplete information.

[10] IRC § 6662(a).

[11] Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. Treas. Reg. § 1.6664-4(b)(1).

[12] Treas. Reg. § 1.6664-4(b)(1).

[13] *Reynolds v. Comm'r*, 296 F.3d 607, 618 (7th Cir. 2002) ("experience, knowledge and education" provision in regulations was determinative as to taxpayer who was attorney, CPA, and IRS audit supervisor); *Knoll v. Comm'r*, T.C. Memo. 2003-277 (lawyer experienced in tax-advantaged financing liable for accuracy-related penalty for negotiating and structuring settlement agreement to secure tax advantages valid in form but lacking substance).

The negligence penalty was not the primary issue in any of the cases analyzed, but was considered in conjunction with the underlying tax deficiencies. Taxpayers obtained relief from the penalty, in whole or in part, in ten of 54 cases.[14] In five of those cases, the negligence penalty was not upheld because the taxpayer had relied on the advice of a professional tax preparer.[15] Whether a taxpayer reasonably relies on advice of a professional depends on the facts and circumstances of the case and the law applicable thereto. The taxpayer must prove that: (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment.[16]

In the other five cases where taxpayers prevailed, the courts ruled that the taxpayer had a reasonable basis for the tax position taken,[17] that the taxpayer had made a reasonable effort to comply with the tax law[18] or that the taxpayer prevailed on the underlying tax issue giving rise to the penalty.[19]

In the cases where taxpayers did not prevail, the courts found against the taxpayer for a variety of reasons, including that the taxpayer had not reasonably relied on profession-

[14] *Burrus v. Comm'r*, T.C. Memo. 2003-285 (holding penalties not warranted on income related to treating landlord and farming activities separate but sustaining penalties on other undisclosed income); *McDermott v. Comm'r*, T.C. Memo. 2003-269 (underlying items giving rise to penalty, bank deposits, were determined not to be income); *Merritt v. Comm'r*, T.C. Memo. 2003-187 (reasonable reliance on professional negates penalty); *Polone v. Comm'r*, T.C. Memo. 2003-339 (reasonable reliance on professional negates penalty); *Knoll v. Comm'r*, T.C. Memo. 2003-277 (taxpayer had reasonable basis for advance payments but no basis as to treatment of lump sum severance); *Sharp v. Comm'r*, T.C. Summ. Op. 2004-27 (taxpayer's failure to include Social Security benefits in income was honest mistake of law and fact); *Stewart v. Comm'r*, T.C. Summ. Op. 2003-101 (holding penalty not warranted on charitable donation where professional gave advice but sustained on transaction where taxpayer had not sought advice from counsel); *Henry v. Comm'r*, T.C. Summ. Op. 2003-104 (holding penalty not warranted for years taxpayer relied on professional but sustained for years when taxpayer did not); *Kimm v. Comm'r*, T.C. Memo. 2003-215 (holding taxpayer reasonably relied on professional); *Perry Funeral Home, Inc. v. Comm'r*, T.C. Memo. 2003-340 (holding that penalty attributable to the method of accounting for pre-paid funeral contracts was not warranted but that penalty attributable to items conceded by the taxpayer was sustained).

[15] *Polone v. Comm'r*, T.C. Memo. 2003-339; *Kimm v. Comm'r* T.C. Memo. 2003-215; *Merritt v. Comm'r*, T.C. Memo. 2003-187; *Stewart v. Comm'r*, T.C. Summ. Op. 2003-101; and *Henry v. Comm'r*, T.C. Summ. Op. 2003-104.

[16] *Bitker v. Comm'r*, T.C. Memo. 2003-209 (holding reliance was not reasonable because accountant was not given sufficient information to verify expense items and thus, reliance was unreasonable).

[17] *Knoll v. Comm'r*, T.C. Memo. 2003-277 (taxpayer had reasonable basis for advance payments but no basis as to treatment of lump sum severance); and *Burros v. Comm'r*, T.C. Memo. 2003-285 (holding penalties not warranted on income related to treating landlord and farming activities separate but sustaining penalties on other undisclosed income).

[18] *Sharp v. Comm'r*, T.C. Summ. Op. 2004-27 (taxpayer's failure to include Social Security benefits into income was honest mistake of law and fact).

[19] *McDermott v. Comm'r*, T.C. Memo. 2003-269 (underlying items giving rise to penalty, bank deposits, were determined not to be income); and *Perry Funeral Home, Inc. v. Comm'r*, T.C. Memo. 2003-340 (holding that penalty attributable to the method of accounting for pre-paid funeral contracts was not warranted but that penalty attributable to items conceded by the taxpayer was sustained).

als,[20] failed to offer any evidence of reasonable cause,[21] clearly violated applicable tax law and regulations,[22] failed to keep adequate books and records,[23] and did not provide any plausible evidence for a reasonable cause defense.[24] Twenty-nine or 54 percent of the cases litigated were *pro se*, where the taxpayers represented themselves, although the taxpayers named in four of the cases were attorneys themselves.[25] Four of the twenty-nine *pro se* taxpayers were successful in arguing against the negligence penalty in whole or in part.[26]

CONCLUSION

Lack of substantiation for the reasonable cause explanation given by the taxpayer was the most prevalent reason for upholding the negligence penalty in the cases. The negligence penalty is considered for assessment only during the examination process. IRS procedures require the examiner to make every effort to apply the penalty in a fair and consistent manner, to discuss the penalty determination with the taxpayer, solicit the taxpayer's explanation, and to consider the reasonable cause exception to the penalty.[27] However, the application of a negligence penalty involves a facts and circumstance test requiring that IRS personnel exercise the appropriate discretion. The only basis for the application of the IRC § 6662 penalty is to further tax compliance.[28] The fact that almost 20 percent of the taxpayers in litigation on the accuracy-related penalty obtained relief from the courts

[20] *Bitker v. Comm'r,* T.C. Memo. 2003-209; *Hautzinger v. Comm'r*, T.C. Memo. 2003-236; *Hines v. Comm'r*, T.C. Summ. Op. 2004-55; *Kovacevich v. Comm'r*, T.C. Memo 2003-161; and *Hoopengarner v. Comm'r*, T.C. Memo 2003-343.

[21] *Hudspath v. Comm'r*, T.C. Memo. 2004-75; *Israel v. Comm'r*, T.C. Memo. 2003-338; *Jensen v. Comm'r*, T.C. Memo. 2003-249; *Cutts v. Comm'r*, T.C. Summ. Op. 2004-8; *Overby v. Comm'r*, T.C. Summ. Op. 2004-5; *Schmidt v. Comm'r*, T.C. Memo. 2003-325; *Waterfall Farms, Inc. v. Comm'r*, T.C. Memo. 2003-327; and *Weeldreyer v. Comm'r*, T.C. Memo. 2003-324.

[22] *Megibow v. Comm'r*, T.C. Memo. 2004-41; *Sowards v. Comm'r*, T.C. Memo. 2003-180.

[23] *Kikalos v. Comm'r*, T.C. Memo. 2004-82; *Demetree v. Comm'r*, T.C. Memo. 2003-323; *Hawkins v. Comm'r*, T.C. Summ. Op. 2003-154; and *Sowards v. Comm'r*. T.C. Memo. 2003-180.

[24] *Haggart v. Comm'r*, T.C. Summ. Op. 2003-70; *Megibow v. Comm'r*, T.C. Memo. 2004-41; *Hoopengarner v. Comm'r*, T.C. Memo. 2003-343; *Assaad v. Comm'r*, T.C. Memo. 2003-171; *Hines v. Comm'r*, T.C. Summ. Op. 2004-55; *Corduan v. Comm'r*, T.C. Summ. Op. 2004-51; *Viar v. Comm'r*, T.C. Summ. Op. 2004-46; *Gaylord v. Comm'r*, T.C. Memo. 2003-273; *Kent v. Comm'r*, T.C. Summ. Op. 2004-23; *Buck v. Comm'r*, T.C. Memo. 2003-314; *Pyrdum v. Comm'r*, T.C. Summ. Op. 2003-146; *Kwan, v. Comm'r*, T.C. Summ. Op. 2003-119; *Lam v.Comm'r*, T.C. Summ. Op. 2003-100; *Crosson v. Comm'r*, T.C. Memo. 2003-170; *Hardin v. Comm'r*, T.C. Memo. 2004-77.

[25] *Polomo v. Comm'r.*, T.C. Summ. Op. 2003-83; *Sowards v, Comm'r*, T.C. Memo. 2003-180; *Hawkins v. Comm'r*, T.C. Summ.Op.2003-154; and *Hardin v. Comm'r*, T.C. Memo. 2004-77.

[26] *Henry v. Comm'r*, T.C. Summ. Op. 2003-104; *Stewart v. Comm'r*, T.C. Summ. Op. 2003-101;*Sharp v. Comm'r*, T.C. Summ. Op. 2004-27; *McDermott v. Comm'r*, T.C. Memo. 2003-269.

[27] Internal Revenue Manual 4.10.6.4.

[28] *Report on Civil Tax Penalties, Executive Task Force*, Commissioner's Penalty Study, Internal Revenue Service, note 22, pt. I, at 1 (1989); *see also* Richard J. Wood, *Accuracy-Related Penalties: A Question of Values*, 76 Iowa L. Rev. 309 (1991).

suggest that the IRS should study whether its training and procedures for assessing the penalty need fine-tuning,[29] and whether the penalty truly enhances tax compliance.

[29] The IRS uses a computer based program, the "Reasonable Cause Assistant," to assist it in exercising its discretion about whether the penalty should be assessed. IRM 20.1.1.3.5. The Reasonable Cause Assistant (RCA) walks the IRS employee through a decision matrix using a question and answer format. When utilizing technology like the RCA, the IRS must ensure that the technology is a guide for the use of discretion in such cases, rather than a substitute for the exercise of discretion.

LITIGATED ISSUE #6 MOST LITIGATED ISSUE: FAILURE TO FILE PENALTY, IRC § 6651(a)

SUMMARY

Taxpayers litigated 47 cases involving the failure to file penalty in the Federal courts during the 12 months from June 1, 2003, to May 31, 2004.[1] In only two of those cases was the penalty the only issue;[2] the rest contained collateral issues. The IRS prevailed in all but one case, and that case was a split decision.[3]

Taxpayers seek relief from the failure to file penalty by asserting "reasonable cause" for the failure.[4] As the cases reviewed in this report demonstrate, it is sometimes very difficult for taxpayers to meet this standard, and yet, in some instances, a penalty does not seem appropriate. For this and other reasons described more fully in the 2001 *Annual Report to Congress*, the National Taxpayer Advocate reiterates her previous recommendation to broaden the definition of reasonable cause for the failure to file timely tax returns to include taxpayers with a history of compliance who make one-time inadvertent errors.[5]

PRESENT LAW

The United States tax system relies on the willingness of taxpayers to voluntarily and accurately report income, file returns, and pay taxes. The system incorporates penalties and additions to tax to accomplish several goals, primarily to encourage voluntary compliance and deter noncompliance. Penalties and additions to tax not only deter noncompliance by attaching a cost, but also by establishing fairness in the tax system by justly penalizing non compliant taxpayers.[6]

A taxpayer that fails to file a tax return on or before its due date is subject to a late filing penalty of five percent for each month or partial month that the return is not filed, up to

[1] IRC § 6651(a) technically provides for "additions to tax;" however, the phrase "additions to tax" is frequently used interchangeably with "failure to file penalties" and will be referred to throughout this analysis as such. Ira B. Shepard and Martin J. McMahon, Jr., *Recent Developments in Federal Income Taxation the Year 2003*, 6 Fla. Tax Rev. 445, 549 (2003). Courts have held that IRC § 6651(a) is *penal* in nature:

> We are here concerned with a Federal statute designed to secure the timely filing of excise tax returns. Petitioner's failure to timely file such return, while not willful, was due to his negligence in failing to acquaint himself with tax liabilities incident to his business operations. The additions to tax here involved are sanctions which were intended to encourage diligence by taxpayers in the filing of returns. *Reuter v. Comm'r*, 37 T.C. 599, 602 (1961).

[2] *Ozaki v. Comm'r*, T.C. Memo. 2003-213; *Crittenden v. Comm'r*, T.C. Memo. 2003-186.

[3] *Arnold v. Comm'r*, T.C. Memo. 2003-259. In *Arnold v. Commissioner*, the IRS assessed a failure to file penalty in its notice of deficiency and alleged an additional failure to file penalty in its answer to the taxpayer's petition to the Tax Court. The court sustained the penalty from the notice of deficiency but held that the IRS failed to prove the additional penalty asserted in its answer.

[4] A failure to file penalty can only be abated if the taxpayer demonstrates "reasonable cause" for the failure to file a tax return. IRC § 6651(a)(1).

[5] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), 178.

[6] Policy Statement P-1-18 dated August 20, 1998.

a maximum of 25 percent.[7] The penalty is based on the net amount due, which is the tax shown on the return minus any credits the taxpayer is entitled to claim and any payment made by the due date.[8]

If a taxpayer is more than 60 days late in filing, the minimum late filing penalty is either $100 or 100 percent of the unpaid tax due, whichever is smaller.[9] The penalty is mandatory unless the taxpayer can show the failure to file is due to reasonable cause and not willful neglect.[10] To prove reasonable cause, a taxpayer must show that he or she exercised ordinary business care and prudence but nevertheless could not file the return when it was due.[11]

The failure to file penalty generally applies to income, estate, gift, and excise tax returns.[12] The failure to file partnership returns is based on different criteria.[13]

Taxpayers have several options for having failure to file penalty assessments reviewed prior to litigation. If taxpayers can show reasonable cause, frontline IRS employees, including Taxpayer Advocate Service employees, are authorized to abate the failure to file penalty within certain limitations.[14] Taxpayers also have the option of having their case heard by the IRS Appeals function. In some circumstances the Taxpayer Advocate Service can review the penalty and ask an IRS operating division or function to take a "fresh look."

ANALYSIS OF LITIGATED CASES

Forty-seven cases involving the failure to file penalty were litigated in the Federal courts between June 1, 2003, and May 31, 2004.[15] The penalty also appeared in the 2003 National Taxpayer Advocate's *Annual Report to Congress* as the sixth most litigated issue for

[7] IRC § 6651(a)(1). When a taxpayer is subject to an addition to tax for late filing and a .5 percent addition to tax for the failure to pay, the late filing addition to tax is reduced to 4.5 percent per month for the months during which both additions to tax apply, so the combined penalty does not exceed 5 percent per month. IRC § 6651(c)(1).

[8] IRC § 6651(b)(1).

[9] IRC § 6651(a).

[10] IRC § 6651(a)(1).

[11] Treas. Reg. § 301.6651-1(c)(1).

[12] IRC § 6651(a)(1).

[13] IRC § 6698 provides a penalty for failure to file a partnership return of $50 times the number of persons who were partners in the partnership during any part of the taxable year, for each month (or fraction of a month) the failure continues (not to exceed five months), unless the failure is due to reasonable cause.

[14] Internal Revenue Manual 21.1.3.

[15] An initial review found 54 cases where Internal Revenue Code section 6651 was an issue litigated during the period covered by our analysis. This code section includes the failure to file penalty [IRC § 6651(a)(1)], the failure to pay penalty [IRC § 6651(a)(2)] and the fraudulent failure to file penalty [6651(f)]. However, because the majority of these cases involved the failure to file penalty, we focused our analysis on this particular penalty. Three of the cases that included the failure to file penalty also included the failure to pay penalty as a litigated issue.

that year.[16] Forty-six of this year's cases were litigated in the United States Tax Court and one was heard by a district court. A detailed listing of this year's cases can be found in Table 6 in Appendix 2.

Forty-one cases, or 87 percent, involved individual tax returns while five cases concerned business, excise or employment tax returns. One case was consolidated to include both the taxpayer's individual and personal service corporation returns.[17] Of the 42 cases involving individual tax returns, 24 dealt with returns that included or should have included a Schedule C, Profit or Loss from Business. One individual return case contained a Schedule F, Profit or Loss from Farming.[18]

The failure to file penalty was the primary issue in only two of the 47 cases, after concessions or stipulations.[19] The penalty was considered in conjunction with other tax deficiencies in the remaining 45 cases. In all but one case (in which there was a split decision), the court sustained the IRS on failure to file issue. In the split decision, the IRS was sustained as to the portion of the penalty included in the statutory notice of deficiency, but not as to the increase requested in the IRS' answer to the taxpayer's petition. [20]

Attorneys represented taxpayers in 12 cases while 35 taxpayers, or 74 percent, represented themselves without the benefit of counsel (*pro se*). Seven of the taxpayers litigating this issue were attorneys,[21] all but one of whom represented themselves.[22] In one case, both spouses were practicing attorneys.[23]

Taxpayers did not file returns in 19 out of the 47 cases. In one case, the taxpayer did not file for 1996 and 1997, but sent the IRS a Form 1040, U.S. Individual Income Tax Return, for 1998 that claimed a $3,783,344 Earned Income Tax Credit and a $407,246 loss carryover from 1997 that he could not substantiate.[24] The Tax Court ruled the 1998 document did not constitute a valid return since the taxpayer crossed out the words "under penalty of perjury" from the certification above his signature. Another taxpayer submitted a return reporting zero income and expenses and requesting a refund of all taxes withheld from his wages as a postal employee.[25]

[16] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 384.

[17] *Merritt v. Comm'r*, T.C. Memo. 2003-187.

[18] *Burrus v. Comm'r*, T.C. Memo. 2003-285.

[19] *Ozaki v. Comm'r*, T.C. Memo. 2003-213; *Crittenden v. Comm'r*, T.C. Memo. 2003-186.

[20] *Arnold v. Comm'r*, T.C. Memo. 2003-259. The different results on the failure to file issue were due to the taxpayer's failure of proof on the notice of deficiency amount and the Commissioner's failure of proof on the Answer amount.

[21] *Tobkin v. Comm'r*, T.C. Summ. Op. 2004-42; *Mendes v. Comm'r*, 121 T.C. No. 19; *Hawkins v. Comm'r*, T.C. Summ. Op. 2003-154; *Godwin v. Comm'r*, T.C. Memo. 2003-289; *Boyd v. Comm'r*, T.C. Memo. 2003-286; *Smith v. Comm'r*, T.C. Memo. 2003-266; *Merritt v. Comm'r*, T.C. Memo. 2003-187.

[22] *Merritt v. Comm'r*, T.C. Memo. 2003-187.

[23] *Smith v. Comm'r*, T.C. Memo. 2003-266.

[24] *Overton v. Comm'r*, T.C. Memo. 2003-344.

[25] *Israel v. Comm'r*, T.C. Memo. 2003-338.

Taxpayers in 27 cases offered no arguments or evidence as to why they should not be penalized for failing to file timely tax returns. In three other cases, it could not be established whether any evidence was presented. Seventeen taxpayers presented arguments as to why they should not be penalized, but none was able to establish reasonable cause for not filing timely. Their arguments included:

- reliance on an employee who did not file tax returns and embezzled company funds;[26]
- chronic depression;[27]
- mental illness;[28]
- reliance on an attorney or representative to prepare and file the return;[29] and
- "mental illness caused by the failure of the U.S. Government to acknowledge that violation of constitutional and civil rights of Japanese Americans during World War II has debilitating and demoralizing effects on the child of U.S. concentration camp survivors."[30]

The Tax Court consistently rejected reasonable cause arguments based on the reliance of a tax preparer or attorney, citing, among other things, that filing a timely tax return is a "personal and nondelegable" duty.[31] In determining whether illness constituted reasonable cause for failing to timely file, the court considered other events occurring during the same time. The court acknowledged one taxpayer had been treated for mental illness, but noted that the illness did not prevent him from bringing suit against a former employer, preparing the complaint and a pre-arbitration memorandum, and negotiating a settlement during the same period.[32]

CONCLUSION

The failure to file penalty was enacted to help taxpayers understand that noncompliance is not appropriate conduct and to establish fairness by penalizing those taxpayers who do not adhere to filing timelines.[33] The due date for filing individual tax returns is common knowledge and is routinely publicized by the IRS and the media. However, the failure to file penalty continues to be litigated frequently in the courts.[34] Sixteen more cases

[26] *Huffman, Carter & Hunt, Inc. v. U.S.*, 317 F. Supp. 2d 816 (2004).

[27] *Tobkin v. Comm'r*, T.C. Summ. Op. 2004-42.

[28] *Tamberella v. Comm'r*, T.C. Memo. 2004-47.

[29] *Mendes v. Comm'r*, 121 T.C. 308 (2003); *Merritt v. Comm'r*, T.C. Memo. 2003-187; *Assaad v. Comm'r*, T.C. Memo. 2003-171.

[30] *Ozaki v. Comm'r*, T.C. Memo. 2003-213.

[31] *Assaad v. Comm'r*, T.C. Memo. 2003-171.

[32] *Tamberella v. Comm'r*, T.C. Memo. 2004-47.

[33] *Reuter v. Comm'r*, 37 T.C. 599, 602 (1961).

[34] The failure to file penalty has appeared as a most litigated issue in the 2000, 2001, and 2003 Annual Reports to Congress. The 2000 report groups all penalties together while the 2001 report combines the failure to file and failure to pay penalties.

involving this issue were brought before the courts in the period reviewed for this report compared to last year. In only two (four percent) cases was the failure to file penalty the only issue litigated. The remaining 45 cases had other deficiencies considered in conjunction with the penalty. All of the taxpayers were seeking full removal of the penalty either for reasonable cause, or by eliminating the tax liability upon which the computation was based. Taxpayers did not challenge the computation, which is generally computer-based and generated by comparing the required due date of a return with its received date, and which is automatically recalculated if the tax upon which it is based is changed.

The IRS should study whether this penalty positively impacts tax compliance as intended. Further, Congress should again consider the National Taxpayer Advocate's proposed one-time abatement of the failure to file penalty.[35] This proposal would broaden the definition of reasonable cause and give the IRS the authority to abate a late filing penalty for inadvertent taxpayer mistakes while still supporting the IRS' mission of encouraging voluntary compliance in a fair and effective tax system.

[35] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), 188. This provision was included in the House-passed Taxpayer Protection and IRS Accountability Act of 2003. See H.R. 1528, 108th Cong. § 106 (2003).

MOST LITIGATED

MOST LITIGATED TAX ISSUES

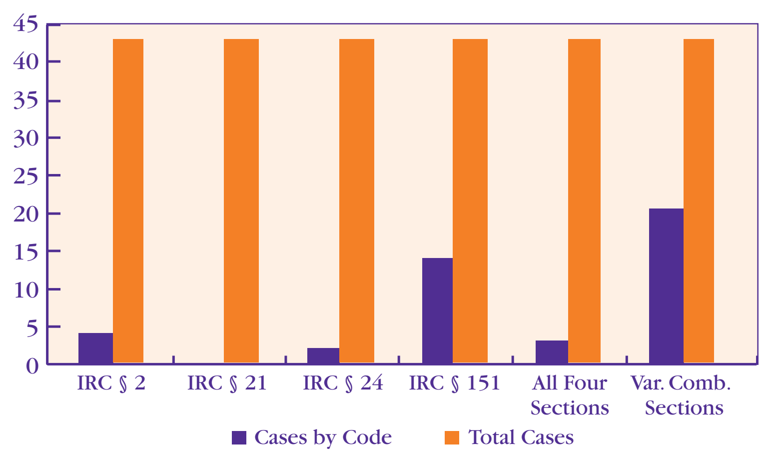
MOST LITIGATED ISSUES: FAMILY STATUS

SUMMARY

Disputes involving the dependency exemption,[1] head of household status,[2] child and dependent care credits, [3] and child credits[4] are often raised in the same cases and revolve around differing appreciations of a core set of facts and circumstances. Therefore, this Report has grouped these issues into a combined category (Family Status). Litigated Family Status issues stem from the exemptions, credits, and filing status that taxpayers with families claim when they prepare and file their Federal tax returns. Head of household filing status is more favorable for a qualifying individual than filing as either a single taxpayer or as married filing separately. The child tax credit, dependency exemption, and the child and dependent care credit are available as additional deductions for qualified individuals and families.

During our review period (June 1, 2003, through May 31, 2004), 44 cases regarding these issues were litigated in Federal courts. The following chart illustrates the extent to which the dependency issue under Internal Revenue Code § 151 is an issue in other Family Status issues and reflects the extent to which many of these provisions have been litigated together.

TABLE 3.7.1, FAMILY STATUS LITIGATED ISSUES BY IRC SECTION[5]



[1] IRC § 151.

[2] IRC § 2.

[3] IRC § 21.

[4] IRC § 24.

[5] IRC § 2 governs the head of household filing status; IRC § 21 governs the child and dependent care credit; IRC § 24 governs the child tax credit; and IRC § 151 governs the dependency exemptions.

PRESENT LAW[6]

Internal Revenue Code §151 governs the use of personal and dependency exemptions as deductions in the computation of taxable income. Each taxpayer may claim personal exemptions and additional exemptions for each dependent as that term is defined in IRC § 152. For 2004 and earlier, to qualify as a dependent an individual must fall into one of nine possible relationship categories and satisfy a number of other qualifying provisions.[7]

Head of household filing status, as described in IRC § 2(b), provides a tax rate that is usually more beneficial than the rate for the single or married filing separately statuses and also provides a higher standard deduction for qualified taxpayers.[8] To qualify, a taxpayer must: (1) be unmarried (single, divorced or legally separated) or "considered unmarried" at the end of the taxable year;[9] and (2) maintain as his or her home a household which constitutes, for more than one-half of such taxable year, the principal place of abode of an individual for whom the taxpayer is entitled to a dependency exemption under IRC § 151.[10] Therefore, head of household status is contingent on qualifying for the IRC § 151 dependency exemption, with one exception: if a parent provides a home to a son or daughter and contributes more than 50 percent towards the maintenance of the home, the taxpayer can qualify as a head of household notwithstanding the inability to qualify for the dependency exemption.[11]

6 The Working Families Tax Relief Act, Pub. L. No. 108-311 (2004) (WFTRA) made changes to family status definitions that affect all Code sections discussed here. WFTRA will take effect starting in 2005. Discussion in this section reflects Code provisions for 2004 and earlier.

7 IRC § 151(c) provides the additional exemption for each dependent who: (A) has gross income for the taxable year less than the exemption amount, or (B) is a child of the taxpayer who (i) has not attained the age of 19 at the close of the calendar year, or (ii) is a student who has not attained the age of 24 at the close of such calendar year. IRC § 152 provides the definition of a dependent as follows: A dependent is an individual who is a U.S. citizen and receives more than half of his or her support from the taxpayer and is either: (1) A son or daughter of the taxpayer, or a descendant of either, (2) A stepson or stepdaughter of the taxpayer, (3) A brother, sister, stepbrother, or stepsister of the taxpayer, (4) The father or mother of the taxpayer, or an ancestor of either, (5) A stepfather or stepmother of the taxpayer, (6) A son or daughter of a brother or sister of the taxpayer, (7) A brother or sister of the father or mother of the taxpayer, (8) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer, or (9) An individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to § 7703, of the taxpayer) who, for the taxable year of the taxpayer, has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household. IRC § 152(a). Additionally, a child meets the definition of dependent if that child: (a) is the legally adopted child of the taxpayer; (b) is a member of the individual's household through placement by an authorized placement agency for legal adoption by the taxpayer; and (c) is the foster child of the individual and, for the taxable year of that taxpayer, resides with the taxpayer and is a member of that household. IRC § 152(b)(2).

8 For tax year 2004, the standard deduction for head of household will be $7,150 (Rev. Proc. 2003-85).

9 IRC § 2(b)(1)(A). For certain purposes, including head of household filing status, some married individuals can be "considered unmarried." IRC § 7703(b). A taxpayer will not qualify for head of household status if he or she is a surviving spouse as defined in IRC § 2(a).

10 IRC § 2(b)(1).

11 A taxpayer may qualify as head of household if the taxpayer is not eligible for the dependency exemption provided that the taxpayer maintains a household for a son or daughter and is unmarried at the end of the year. To maintain a household, the taxpayer must pay more than fifty percent of the cost to maintain the home. Treas. Reg. § 1.2-2(b)(3)(i).

The child and dependent care credit, as codified in IRC § 21, allows a credit against taxes due based on a percentage of expenses incurred by taxpayers for the care of "qualifying individuals" in order to work, provided the taxpayers maintain a household that includes one or more of the qualifying individuals.[12] Dependency under IRC § 151 or status as a taxpayer's spouse is required in order to be eligible for the credit, although there are additional requirements as well. To qualify under IRC § 21, the taxpayer must claim a dependency exemption under IRC § 151 for any of the following:

- an individual under the age of 13;
- a dependent over the age of 13 for whom an individual qualifies for the dependency exemption under IRC § 151 and who is physically or mentally incapable of self-care; or
- a spouse who is physically or mentally incapable of caring for him or herself.[13]

For 2004 and earlier, the Code requires that the individual maintain a household that included the qualifying individual.[14]

The child tax credit under IRC § 24 provides a credit against taxes due and a possible refund for taxpayers with a qualifying child or children.[15] In tax years 2002 and 2003, taxpayers who had previously claimed a qualifying child received advance payments of the child tax credit[16] and when filing their returns, they reduced the credit by the amount of that advance payment.[17] A qualifying child under the child tax credit must be a child for whom the taxpayer can qualify for the dependency exemption, provided the qualifying child has not reached the age of 17 and satisfies a relationship test.[18] The relationship test for the child tax credit and the Earned Income Tax Credit (EITC) are both narrower than the dependency exemption test; this distinction has resulted in some litigation.

ANALYSIS OF LITIGATED CASES

The tax laws controlling Family Status issues are interrelated. For taxpayers to claim the credits under the child and dependent care credit and the child credit, there must be a "qualifying individual" (in the case of IRC § 21) or a "child" (in the case of IRC § 24)

[12] IRC § 21(a)(1).

[13] IRC § 21(b).

[14] IRC § 21(e)(1). Starting in 2005, the maintenance of a household test is replaced by a "principal place of abode" test.

[15] IRC § 24.

[16] IRC § 6429(b).

[17] IRC § 6429(d).

[18] IRC § 24 adopts the Earned Income Tax Credit relationship test in IRC § 32(c)(3)(B) (an individual bears a relationship to the taxpayer described in this subparagraph if such individual is (i) a son, daughter, stepson, or stepdaughter, or a descendant of any such individual, (ii) a brother, sister, stepbrother, or stepsister, or a descendant of any such individual, who the taxpayer cares for as the taxpayer's own child, or (iii) an eligible foster child of the taxpayer.

meeting the IRC § 151 dependency exemption requirements. In most instances, the dependency exemption requirement is also needed to qualify for head of household filing status. As a result, the issues in 38 of the 44 Family Status cases required a determination of the dependency exemption as part of their resolution.

Pro Se Analysis

Having set out the complex web of the Internal Revenue Code provisions affecting Family Status issues, it is important to note here that only three of the 44 litigants in Family Status cases (or seven percent) were represented by counsel, while the rest were *pro se*. Legal representation is always advisable in litigation. However, the complexity of tax issues combined with the heavily fact-driven analysis required to resolve Family Status issues suggests that taxpayers without legal representation are at a serious disadvantage when litigating these controversies with the IRS.

The Dependency Exemption - IRC § 151

The dependency exemption under IRC § 151 was litigated in 38 cases, with 15 of them involving only the dependency issue while the remaining 23 cases dealt with other Family Status issues as well. To resolve most of the 38 cases, the court was required to rule on the definition of a dependent under IRC § 152.

Fifteen of the dependency exemption cases concerned IRC § 152(e), which determines who is eligible to claim the dependency exemption where the parents are divorced.[19] These cases primarily involved the factual question of whether the parent claiming the exemption provided the requisite amount of support to the claimed dependent. Further, IRC §152 (e) presumptively allows the dependency exemption to the custodial parent with certain exceptions.[20] One of these exceptions allows the non-custodial parent to take the dependency exemption if the custodial parent releases the claim by signing Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, which states that he or she will not claim that child for the tax year in question. The non-custodial parent then attaches that written declaration to his or her tax return.[21]

[19] *Brissett v. Comm'r*, T.C. Memo 2003-310; *Burke v. Comm'r*, T.C. Summ. Op. 2003-147; *Crowell v. Comm'r*, T.C. Summ. Op. 2003-134; *Dail v. Comm'r*, T.C. Memo 2003-211; *Hamilton v. Comm'r*, T.C. Summ. Op. 2003-85; *Izac v. Comm'r*, T.C. Summ. Op. 2003-86; *James v. Comm'r*, T.C. Summ. Op. 2003-118; *King v. Comm'r*, 121 T.C. 12 (2003); *Martinez v. Comm'r*, T.C. Summ. Op. 2003-128; *McCullar v. Comm'r*, T.C. memo 2003-272; *Planko v. Comm'r*, T.C. Summ. Op. 2003-105; *Schroeder v. Comm'r*, T.C. Summ. Op. 2003-80; *Stone v. Comm'r*, T.C. Summ. Op. 2004-43; *Thompson v. Comm'r*, T.C. Summ. Op. 2003-73; *Womack v. Comm'r* T.C. Memo 2003-182.

[20] IRC § 152(e)(2). Other exceptions exist under IRC § 152 for multiple-support agreements and pre-1985 divorce instruments.

[21] Taxpayers may attach a written statement in lieu of the form but it must contain the same information as the Form 8332. Treas. Reg. § 1.152-4T, Q&A 3.

Seven of the cases with a dependency issue involved Form 8332.[22] In these cases, the form was either not obtained by the non-custodial parent or not attached to the non-custodial parent's return; the parent used a substitute for Form 8332, such as the copy of the divorce decree; or, as in one case, the Form 8332 was found to have been altered by the non-custodial spouse.[23] Two cases involved the issue of whether the dependent was a full-time student under IRC § 151(c)(4).[24]

In 19 dependency cases, the issue under § 152(a) was whether the requisite relationship was present to establish dependency or whether the taxpayer provided the requisite "support."[25] For example, in *Molina v. Commissioner*, the taxpayer claimed dependency exemptions for her daughter, mother and niece, arguing that they fell within the relationship test of IRC § 152(a) and the taxpayer provided the requisite support under that provision.[26] The IRS disallowed the dependency exemptions on the grounds that the taxpayer's own self-serving testimony was the only evidence to back up the assertion that these individuals lived with the taxpayer and she provided the requisite support. The IRS argued that the United States Tax Court generally does not rely upon an individual taxpayer's testimony to meet the burden of proof; however, the court held that oral testimony is sufficient evidence where the testimony is credible and uncontroverted by other evidence.[27] While the issues in *Molina v. Commissioner* are typical of the Family Status issues litigated in the Tax Court, as is discussed further below, the outcome in favor of the taxpayer in *Molina* is atypical, particularly where, as in this case, the taxpayer was not represented by counsel.

In contrast to *Molina v. Commissioner*, the Tax Court in *Gaylord v. Commissioner* held that the taxpayer's unsubstantiated oral testimony was insufficient to carry her burden of

[22] *Brissett v. Comm'r*, T.C. Memo 2003-310; *Burke v. Comm'r*, T.C. Summ. Op. 2003-147; *Crowell v. Comm'r*, T.C. Summ. Op. 2003-134; *Hamilton v. Comm'r*, T.C. Summ. Op. 2003-85; *James v. Comm'r*, T.C. Summ. Op. 2003-118; *King v. Comm'r*, 121 T.C. 12 (2003); *Martinez v. Comm'r*, T.C. Summ. Op. 2003-128; *Stone v. Comm'r*, T.C. Summ. Op. 2004-43.

[23] In *Crowell v. Comm'r*, T.C. Summ. Op. 2003-134, the divorced custodial spouse acknowledged signing the form for 1995 but not the other 11 years reflected on the Form 8332. The court found sufficient evidence that the non-custodial parent had altered Form 8332 to include the additional 11 years without the custodial spouse's consent.

[24] *Mudd v. Comm'r*, T.C. Summ.Op. 2004-1; *Santilla v. Comm'r*, T.C. Summ. Op. 2004-24.

[25] *Betancourt v. Comm'r*, T.C. Summ. Op. 2004-61; *Brinson v. Comm'r*, T.C. Summ. Op. 2003-89; *Cantrell v. Comm'r*, T. C. Summ. Op. 2004-52; *Cavender v. Comm'r*, T.C. Memo 2004-33; *Corduan v. Comm'r*, T.C. Summ. Op. 2004-51; *Gilmore v. Comm'r*, T.C. Summ. Op. 2004-38; *Hernandez v. Comm'r*, T.C. Summ. Op. 2003-144; *Howard v. Comm'r*, T.C. Summ. Op. 2003-124; *Kent v. Comm'r*, T.C. Summ. Op. 2004-23; *Linton v. Comm'r*, T.C. Memo 2003-160; *Lisi v. Comm'r*, T.C. Summ. Op. 2003-132; *Mehner v. Comm'r*, T.C. Memo 2003-203; *Mendes v. Comm'r*, 121 T.C. 19 (2003); *Molina v. Comm'r*, T.C. Memo 2003-254; *Prince v. Comm'r*, T.C.Memo 2003-247; *Rice v. Comm'r*, T.C. Memo 2003-208; *St. Hilaire v. Comm'r*, T.C. Summ. Op. 2003-102; *Taylor v. Comm'r*, T.C. Summ. Op. 2003-133; *Webb -Reed v.Comm'r*, T.C. Summ. Op. 2004-6.

[26] *Molina v. Comm'r*, T.C. Memo. 2003-254.

[27] *Id*.

proof. [28] The taxpayer claimed a dependency deduction for her brother who lived with her and for whom the taxpayer paid all living expenses. The court held that the unsubstantiated testimony of the taxpayer was insufficient to prove the place of residency and amount of support provided. In this case, however, the court noted that even had the taxpayer sufficiently proven her case, the dependency exemption would have been denied because the claimed dependent had earned gross income in excess of the exemption amount allowable under IRC § 151(c)(1)(A) and (d)(1).[29]

Head of Household Filing Status - IRC § 2

The head of household issue was litigated in 22 cases. Four of these involved only the head of household issue while the rest also dealt with other Family Status issues.[30] In 18 of the 18 cases with multiple issues, the head of household filing status and the dependency exemption under IRC §151 were denied. In one case, the taxpayer was allowed the head of household filing status while being denied the dependency exemption for the qualifying child.[31]

Head of household status requires that the taxpayer be unmarried (single, divorced or legally separated) or "considered unmarried" at the end of the taxable year.[32] Three cases involved determinations of the taxpayers' marital status under IRC § 7703, which treats married individuals as unmarried in certain limited circumstances. [33] In all three cases, the court found that the taxpayers did not meet any of the tests that allowed married persons to be treated as unmarried.

Some of the head of household cases provide particularly good examples of the confusion many taxpayers encounter when applying the complex family status provisions to their own particular situations. For example, in *Elsawah v. Commissioner*, the taxpayer claimed

MOST LITIGATED TAX ISSUES

---

[28] *Gaylord v. Comm'r*, T.C. Memo 2003-273.

[29] *Id*.

[30] *Ahmed v. Comm'r*, T.C. Summ. Op. 200420; *Betancourt v. Comm'r*, T.C. Summ. Op. 2004-61; *Brinson v. Comm'r*. T. C. Summ. Op. 2003-89; *Cantrell v. Comm'r*, T. C. Summ. Op. 2004-52; *Corduan v. Comm'r*, T. C. Summ. Op. 2004-51; *Dail v. Comm'r*, T. C. Memo. 2003-211; *Elsawah v. Comm'r*, T.C. Summ. Op.2004-33; *Francisco v. Comm'r*, T. C. Summ. Op. 2004-4; *Gaylord v. Comm'r*, T.C. Memo. 2003-273; *Gilmore v. Comm'r*, T. C. Summ. Op. 2004-38; *Hamilton v. Comm'r*, T.C. Summ. Op. 2003-85; *Hernandez v. Comm'r*, T.C. Summ. Op.2003-144; *Kent v. Comm'r*, T.C. Summ. Op. 2004-23; *Linton v. Comm'r*, T.C. Memo. 2003-160; *Mbanu v. Comm'r*, T.C. Summ. Op. 2004-58; *McCullar v. Comm'r*, T.C. Memo. 2003-272; *Molina v. Comm'r*, T.C. Memo. 2003-254; *Planko v. Comm'r*, T.C. Summ. Op. 2003-105; *Prince v. Comm'r*, T.C. Memo. 2003-247; *St. Hilaire v. Comm'r*, T.C. Summ. Op. 2003-102; *Taylor v. Comm'r*, T.C. Summ. Op. 2003-103; *Thompson v. Comm'r*, 2003-73; *Webb-Reed v. Comm'r*, T.C. Summ. Op. 2004-6.

[31] *Cantrell v. Comm'r*, T. C. Summ. Op. 2004-52.

[32] IRC § 7703(b) provides that certain married taxpayers are "considered unmarried." To be considered unmarried,: (1) an individual must maintain a home for more than one half of the taxable year which is the principal residence of a child for whom a dependency exemption can be claimed;.(2) an individual must furnish one half of the cost of maintaining the home; and (3) an individual's spouse must not a member of that household during the last 6 months. IRC § 7703(b)(1)-(3).

[33] *Ahmed v. Comm'r*, T.C. Summ. Op. 200420; *Elsawah v. Comm'r*, T.C. Summ. Op.2004-33; *Francisco v. Comm'r*, T. C. Summ. Op. 2004-4.

the head of household status even though he was still married under the laws of California.[34] The taxpayer, representing himself *pro se*, argued that IRC § 7703 (treating some married individuals as unmarried under certain circumstances) applied to his situation because he and his spouse had received an Islamic divorce, his wife lived in the basement, and she spent very little time there since she was involved in another relationship. The Tax Court held that, in spite of their Islamic divorce, the couple had not satisfied the IRC § 7703 requirement that the taxpayer and spouse live apart for six months, due to the spouse residing in the basement. The taxpayer argued that the instructions provided by IRS publications were confusing because they do not specifically state that taxpayers must have separate geographic residences, but rather that taxpayers may "not have lived together." This case illustrates the difficulties taxpayers encounter not only due to tax law complexity but also due to cultural differences.[35]

The Child Tax Credit - IRC § 24

The child tax credit was litigated in 14 cases, two concerning that issue only and the other 12 also involving other Family Status issues.[36] In these 12 cases, the child tax credit was denied because the dependency exemption under IRC § 151 was denied.[37] By contrast, in *Echevarria v. Commissioner*, the taxpayer was awarded the dependency exemption but denied the child tax credit.[38] Here, the taxpayer lived with a woman and her child and cared for the child as his own. The IRS conceded before trial that the taxpayer was entitled to the head of household filing status and the child's dependency exemption. However, the court found the child was not a qualifying child for purposes of the child tax credit because the relationship test described in IRC § 24(c)(1)(c) was not met.[39] Having a qualifying child by itself is insufficient to meet the dependency exemption

[34] *Elsawah v. Comm'r*, T.C. Summ. Op.2004-33.

[35] *Id.*

[36] *Betancourt v. Comm'r*, T.C. Summ. Op. 2004-61; *Cantrell v. Comm'r*, T.C. Summ. Op. 2004-52; *Echevarria v. Comm'r*, T.C. Summ. Op. 2003-92; *Gilmore v. Comm'r*, T.C. Summ. Op. 2004-38; *Hamilton v. Comm'r*, T.C. Summ. Op. 2003-85; *Hernandez v. Comm'r*, T.C. Summ. Op. 2003-144; *Izac v. Comm'r*, T.C. 2003-86; *Martinez v. Comm'r*, T.C. Summ. Op. 2003-128; *McCullar v. Comm'r*, T.C. Memo 2003-272; *Schroeder v. Comm'r*, T.C. Summ. Op. 2003-80; *St. Hilaire v. Comm'r*, T.C. Summ. Op. 2003-102; *Stone v. Comm'r*, T. C. Summ. Op.2004-43; *Webb-Reed v. Comm'r*, T.C. Summ. Op. 2004-6; *Young v. Comm'r*, T.C. Summ. Op. 2003-170.

[37] *Betancourt v. Comm'r*, T.C. Summ. Op. 2004-61; *Cantrell v. Comm'r*, T.C. Summ. Op. 2004-52; *Gilmore v. Comm'r*, T.C. Summ. Op. 2004-38; *Hamilton v. Comm'r*, T.C. Summ. Op. 2003-85; *Hernandez v. Comm'r*, T.C. Summ. Op. 2003-144; *Izac v. Comm'r*, T.C. 2003-86; *Martinez v. Comm'r*, T.C. Summ. Op. 2003-128; *McCullar v. Comm'r*, T.C. Memo 2003-272; *Schroeder v. Comm'r*, T.C. Summ. Op. 2003-80; *St. Hilaire v. Comm'r*, T.C. Summ. Op. 2003-102; *Stone v. Comm'r*, T. C. Summ. Op.2004-43; *Webb-Reed v. Comm'r*, T.C. Summ. Op. 2004-6.

[38] *Echevarria v. Comm'r*, T.C. Summ. Op. 2003-92.

[39] *Id.*

under IRC § 24(c)(1)(c), and the taxpayer must satisfy two additional requirements, age and relationship.[40]

The Child and Dependent Care Credit - IRC § 21

The child and dependent care credit was litigated as part of other Family Status issues in four cases. In each instance, the taxpayer was allowed the credit only if the qualifying child was his or her dependent under IRC § 151. Three of these cases are discussed in the following section, "Family Status Cases with Combined Issues."

Family Status Cases with Combined Issues

Three litigated cases encompassed all four Family Status issues.[41] Two of these cases demonstrate the complexity of the tax law issues faced by taxpayers, particularly lower income taxpayers.

In *St. Hilaire v. Commissioner*, the taxpayer filed a return for tax year 2000 using the head of household filing status and claiming the child tax credit and the child and dependant care credit with his minor son as qualifying child.[42] At trial, the taxpayer claimed he and his son lived apart from his wife in one room of an apartment with another family but took their meals, which his wife prepared in a different home, with her and their other children. He and his son would then return to the separate apartment to sleep. Evidence did indicate that the taxpayer's wife lived in her own apartment, and the taxpayer paid most of the expenses to maintain his wife's residence. The Tax Court's ruling evidences the complexity of the Internal Revenue Code and the counterintuitive results that sometimes result from the application of facts to the law. The court ruled that the taxpayer could not use the head of household filing status because he was still married. Although the taxpayer asserted IRC § 7703(a)(2), which deems married individuals as unmarried in certain situations, the court held that the child's mother played *too much* of a role in the child's life to fall within the confines of IRC § 7703(a)(2). The court went on to deny the child and dependent care credit because the taxpayer was married and did not file a joint return, nor could he provide documentation to substantiate the expenses. However, the court was satisfied that the taxpayer had paid more than 50 percent of the child's support, meeting the remaining requirements of IRC §§ 151 and 152, and allowed the dependency exemption and the child tax credit.

[40] IRC § 24(c). A "qualifying child" under this section means any individual if: (A) the taxpayer is allowed a deduction under IRC § 151 with respect to such individual for the taxable year, (B) such individual has not attained the age of 17 as of the close of the calendar year in which the taxable year of the taxpayer begins, and (C) such individual bears a relationship to the taxpayer described in IRC § 32(c)(3)(B).

[41] *Cantrell v. Comm'r*, T.C. Summ. Op. 2004-52; *St. Hilaire v. Comm'r*, T.C. Summ. Op. 2003-102; *Webb-Reed v. Comm'r*, T.C. Summ. Op. 2004-6.

[42] *St. Hilaire v. Comm'r*, T.C. Summ.Op. 2003-102.

Cantrell v. Commissioner involved a single mother claiming dependency exemptions as well as the Earned Income Tax Credit and the child tax credit.[43] The mother used the head of household filing status, claimed the child and dependent care credit and the rate reductions credit. Although the taxpayer's children lived with her, the Tax Court disallowed the dependency exemptions for the taxpayer because housing subsidies and support from the father amounted to more than 50 percent of the total support the children received. The holding on dependency automatically precluded the taxpayer from being eligible for the child tax credit and child and dependent care credit. However, the court found in favor of the taxpayer on the head of household filing status since she was unmarried and was caring for her children in a home to which she contributed over 50 percent of expenses. We note here that, because WFTRA eliminated the "support" test for children under 19 who reside with their parent for more than half the year, the taxpayer would have been allowed the dependency exemption, and therefore, the child tax credit and dependent care credit under post-2004 law.

CONCLUSIONS

Our analysis of Family Status cases determined that only three of the 44 litigants were represented by counsel. In 20 percent of the total cases, the court found for the taxpayer or provided a split decision, although three of these were "whipsaw" cases which required the court to resolve conflicting claims between different taxpayers. In almost 50 percent of the cases in which the IRS position was sustained, the taxpayer provided little or no evidence or offered evidence that the court found "self-serving."

While these taxpayers failed to provide adequate evidence to support their positions, the analysis and holdings regarding Family Status issues suggest a level of legal complexity that may be beyond the comprehension of many taxpayers. This complexity makes it difficult for taxpayers to interpret the laws and apply them to the facts of their individual situations. While legal representation would have been helpful to these taxpayers, simplification of the tax law provisions affecting lower-to-middle income taxpayers may reduce the number of Family Status cases reaching the courts. The WFTRA changes would have resulted in a different result in at least one of the cases discussed here.

[43] *Cantrell v. Comm'r*, T.C. Summ.Op. 2004-52.

LITIGATED ISSUE #8 MOST LITIGATED ISSUE: IRC § 6673 FRIVOLOUS ISSUES PENALTIES

SUMMARY

Thirty-five cases were litigated during the review period on the issue of whether or not a taxpayer conducted litigation against the IRS primarily for delay or advanced frivolous or groundless litigation positions under Internal Revenue Code § 6673. This penalty is assessed against taxpayers for maintaining a case in the United States Tax Court primarily for delay, for maintaining frivolous or groundless arguments or for unreasonably failing to pursue available administrative remedies.[1] The IRS prevailed in 33 of the 35 cases on the penalty issue. In 89 percent of the cases where the IRC § 6673 penalty was litigated (31 cases), the taxpayers were *pro se*, or without the benefit of counsel.

PRESENT LAW

Internal Revenue Code § 6673 provides penalty sanctions for both the United States Tax Court and other Federal courts. In the Tax Court, penalties not exceeding $25,000 can be assessed against a taxpayer for instituting a case primarily for delay, for advancing a position that is groundless or frivolous, or for failing to pursue other administrative remedies.[2] Counsel fees can also be assessed against any attorney practicing before the Tax Court who unreasonably delays or multiplies proceedings before the court.[3] Penalties not exceeding $10,000 can also be assessed against taxpayers in other Federal courts when the court determines that the taxpayer is asserting a frivolous claim under IRC § 7433.[4] In addition, Federal laws and rules of procedure allow the other Federal courts to impose penalties for frivolous arguments and vexatious litigation tactics.[5] However, this analysis covers only IRC § 6673 due to the number of cases involving this section of the Code.

1 IRC § 6673(a)(1)(A), (B), and (C). Additionally, this provision contains a penalty against taxpayers for maintaining a frivolous suit in a U.S. District Court against the IRS for an unauthorized collection of federal tax. IRC § 6673(b)(1) (none of the cases reported on in this analysis pertained to such cases).

2 IRC § 6673(a)(1).

3 IRC § 6673(a)(2).

4 IRC § 7433 allows taxpayers a cause of action against the IRS, as follows:

If, in connection with any collection of Federal tax with respect to a taxpayer, any officer or employee of the Internal Revenue Service recklessly or intentionally, or by reason of negligence disregards any provision of this title, or any regulation promulgated under this title, such taxpayer may bring a civil action for damages against the United States in a district court of the United States. Except as provided in section 7432 such civil action shall be the exclusive remedy for recovering damages resulting from such actions.

5 28 U.S.C.A. § 1927 (providing sanctions against attorneys in Federal courts for unduly multiplying and delaying proceedings); 28 U.S.C.A. § 1912 (providing that costs and damages can be assessed against a party for taking frivolous appeal); Fed. R. Civ. P. 11(b) (providing for sanctions against any person for advancing arguments or claims that have no basis or serve only to harass); *see* Fed. R. Civ. P. 38 (allowing Federal courts of appeal to award damages to opposing party for frivolous appeal).

Courts have ascribed a general purpose for imposing IRC § 6673 penalties:

> The purpose of section 6673 is to compel taxpayers to think and to conform their conduct to settled principles before they file returns and litigate.[6]

ANALYSIS OF LITIGATED CASES

Thirty-five cases involving the penalty under IRC § 6673 for instituting or maintaining proceedings before the U.S. Tax Court primarily for delay, or for maintaining frivolous or groundless positions, were litigated in the Federal court system from June 1, 2003 through May 31, 2004. A detailed listing of the cases may be found in Table 8 in Appendix 2.

Taxpayers essentially presented five different arguments which the U.S. Tax Court deems patently frivolous:

- The notice of deficiency was invalid because the person sending it lacked sufficient authority;[7]
- The notice of deficiency was invalid because no return was ever filed;[8]
- Income from wages and other types of income is not taxable;[9]
- IRS failed to give proper certificates of assessment and otherwise failed to notify taxpayer of taxing authority in the Internal Revenue Code; [10] and

[6] *Coleman v. Comm'r*, 791 F.2d 68, 71 (7th Cir. 1986); *Trowbridge v. Comm'r*, T.C. Memo. 2003-164.

[7] *Israel v. Comm'r*, T.C. Memo. 2003-338 (holding $5,000 penalty was warranted where Tax Court had previously imposed a $1,500 penalty against the taxpayer in another case for raising frivolous issues, had warned the taxpayer numerous times in this case that the issues raised were frivolous and had ruled the same argument as frivolous in numerous other cases).

[8] *Johnston v. Comm'r*, T.C. Memo. 2004-107 (holding $5,000 penalty was warranted where Tax Court repeatedly warned the taxpayers that their arguments were frivolous); *Dunham v. Comm'r*, T.C. Memo. 2003-260 (holding $5,000 penalty was warranted where taxpayers advanced boilerplate frivolous type arguments).

[9] *Wos v. Comm'r*, T.C. Memo. 2003-223; *Carskadon v. Comm'r*, T.C. Memo. 2003-237 (holding $2,000 penalty warranted); *Rayner v. Comm'r*, 92 A.F.T.R.2d (RIA) 5151 (5th Cir. 2003) (upholding Tax Court imposition of $5,000 penalty for argument that pension distributions were not income and where taxpayer had history of making frivolous arguments); and *Curtis v. Comm'r*, 92 A.F.T.R.2d (RIA) 5664 (9th Cir. 2003) (taxpayer's argument that rental income is not taxable is a frivolous argument).

[10] *Pepper Pot Trust v. Comm'r*, T.C. Memo. 2003-287 (holding $5,000 penalty was warranted where in an appeal from Collection Due Process hearing taxpayer advanced patently frivolous argument about lack of IRS authority to tax); *Brashear v. Comm'r*, T.C. Memo. 2003-196 (holding that $1,600 penalty was warranted in appeal from CDP hearing where taxpayer questioned IRS' taxing authority).

- IRS failed to satisfy requirement under IRC §§ 6320 and 6330 in Collection Due Process hearings that applicable laws or administrative procedures have been met for IRS to proceed with collection action.[11]

Other conduct, such as unwarranted delays and uncooperative behavior, may also subject taxpayers to penalties under IRC § 6673.[12] In a number of these cases, the Tax Court imposed the penalties *sua sponte*, *i.e.* on its own without having been requested to do so by the IRS.[13]

In only two cases were taxpayers able to prevail in arguing against the imposition of the penalty. Even in these cases, however, the court criticized the arguments made by the taxpayers but decided not to impose the IRC § 6673 penalty for other reasons. In *Moore v. Commissioner*, where the taxpayer objected to the imposition of the Alternative Minimum Tax (AMT), his arguments were generalized statements about the unfairness of imposing the AMT.[14] While the Tax Court deemed the argument frivolous, it spared the taxpayer from the penalty because the court had not yet ruled on a similar argument made by the same taxpayer in a different case.[15]

A similar result occurred in *Hawkins v. Commissioner*, where a taxpayer with tax deficiencies for multiple years argued that the Religious Freedom Restoration Act (RFRA)[16]

[11] *Bethea v. Comm'r*, T.C. Memo. 2003-278 (argument that IRS cannot rely on Form 4340 for verification purposes is frivolous warranting $2,000 penalty); *Brodman v. Comm'r*, T.C. Memo. 2003-230 (holding no particular form of verification is required at CDP hearing and argument on appeal to the contrary was frivolous warranting $5,000 penalty); *Brown v. Comm'r*, T.C. Memo. 2003-261 (imposing $5,000 penalty); *Cipolla v. Comm'r*, T.C. Memo. 2004-6 (imposing $7,500 penalty); *Deputy v. Comm'r*, T.C. Memo. 2003-210 (imposing $2,000 penalty); *Heaphy v. Comm'r*, T.C. Memo. 2004-48 (imposing $3,000 penalty); *Hathaway v. Comm'r*, T.C. Memo. 2004-15 (imposing $10,000 penalty); *Kemper v. Comm'r*, T.C. Memo. 2003-195 ($8,500 penalty imposed for asserting verification argument along with other frivolous arguments); *Jensen v. Comm'r*, T.C. Memo. 2004-120 (imposing $10,000 penalty where taxpayer advances stale frivolous arguments, including argument that IRS failed to verify that all laws and procedures have been followed for IRS to proceed with collection action).

[12] *Trowbridge v. Comm'r*, T.C. Memo. 2003-165 (holding $25,000 penalty was warranted taxpayer made excessive document requests to advance frivolous arguments and attempted to withdraw the petition two weeks before trial); *see also Trowbridge v. Comm'r*, T.C. Memo. 2003-164 (where the same taxpayers were assessed a $15,000 penalty for failing to appear and making frivolous arguments); *Suri v. Comm'r*, T.C. Memo. 2004-71 (holding $1,000 penalty was warranted where taxpayer refused to meet with IRS or provide pre-trial information requests); *Banat v. Comm'r*, 92 A.F.T.R.2d (RIA) 7075 (2nd Cir. 2003) (upholding $2,000 penalty even though taxpayer had withdrawn petition); *Kolker v. Comm'r*, 93 A.F.T.R.2d 2004 (RIA) 2392 (9th Cir. 2004) (upholding $10,000 penalty imposed by Tax Court, holding dismissal of petition does not moot penalty assessment).

[13] *Israel v. Comm'r*, T.C. Memo. 2003-338; *Johnston v. Comm'r*, T.C. Memo. 2004-107l; *Wos v. Comm'r*, T.C. Memo. 2003-223; *Green v. Comm'r*, T.C. Memo. 2003-264 (argument that IRS had no authority to tax warrants Court's imposition of $5,000 penalty); *Frey v. Comm'r*, T.C. Memo. 2004-87 (arguments warranted Tax Court's imposition of $4,000 penalty).

[14] *Moore v. Comm'r*, T.C. Memo. 2003-307.

[15] *Id*.

[16] The RFRA provides that a statute burdens the exercise of religion if it puts substantial pressure on an adherent to modify his behavior and to violate his beliefs. 42 U.S.C.A. § 2000bb-1(a).

deprived the court of jurisdiction to hear the case.[17] The taxpayer had sought to have his religious adviser represent him before the court, although the adviser met none of the requirements set out in Rules 24 and 200 for practice before the Tax Court. When the request was denied, the taxpayer argued he was entitled to judgment as a matter of law. The court noted that such arguments had been rejected in many other cases. However, the court declined to impose the penalty, basing its decision on the fact that it was the taxpayer's first appearance before the Tax Court.[18]

CONCLUSION

In none of the cases reviewed were any genuine issues raised by taxpayers. These taxpayers offered similar arguments, which have been repeatedly raised in litigation and rejected by the courts. The courts consistently held that penalties were warranted where taxpayers advanced boilerplate arguments that were frivolous and without merit. These cases serve as a cautionary warning to taxpayers and their representatives who engage in litigation solely for the purpose of delay. The IRS seeks these penalties in more and more cases and the courts sustain these penalties in the vast majority of cases.

[17] *Hawkins v. Comm'r*, T.C. Memo. 2003-181 (holding that taxpayer's arguments amount to an argument that the Federal tax system burdens his religion and that numerous other cases have ruled against this argument).

[18] *Id.*

LITIGATED ISSUE #9 MOST LITIGATED ISSUE: EARNED INCOME TAX CREDIT (EITC)

SUMMARY

The Earned Income Tax Credit (EITC) is the nation's largest need-based anti-poverty program,[1] providing more than $31 billion in refundable credits to low income working families in 2000.[2] Taxpayers, particularly those with qualifying children, had to meet complex requirements to get the credit. An analysis of litigated cases involving the EITC indicates that many low income taxpayers face difficulties when attempting to comply with the numerous and often confusing EITC requirements. In the majority of cases, there were other tax issues related to family status,[3] such as the dependency exemption,[4] head of household status,[5] child and dependent care credits,[6] and child credit.[7]

Analysis of the cases indicates that some taxpayers lack understanding of the eligibility issues related to the various credits and deductions available for working families with children. The IRS has several initiatives underway to educate taxpayers and their representatives about EITC eligibility. The National Taxpayer Advocate is also attempting to address many of these issues through administrative and legislative recommendations in her Annual Reports to Congress as well as ongoing systemic advocacy initiatives. The 2004 Working Families Tax Relief Act (WFTRA) made changes to family status definitions that may reduce the complexity of these determinations.[8] Because the WFTRA incorporated the previous EITC definitions in IRC § 32 into the other family status provisions, the new law will not affect determinations of EITC eligibility as much as the determination of other family status issues.[9]

PRESENT LAW

The EITC is a refundable Federal income tax credit for low income working taxpayers. Congress originally enacted it in 1975, in part to offset the burden of Social Security taxes and to provide an incentive to work.[10] The EITC has been widely praised for its success in supporting individuals who work and reducing poverty[11] and lifts more children out of

MOST LITIGATED TAX ISSUES

1 Frank Sammartino, Eric Toder and Elaine Maag, *Providing Federal Assistance for Low-Income Families Through the Tax System*: *A Primer*, The Urban-Brookings Tax Policy Center, 8 (July 2002) at http://www.urban.org/uploadedpdf/410526.pdf.

2 *Id*.

3 For additional analysis of family status issues, see this report, Most Litigated Issue, Family Status, p. 364.

4 IRC § 151.

5 IRC § 2.

6 IRC § 21.

7 IRC § 24.

8 Working Families Tax Relief Act, Pub. L. No. 108-311, 118 Stat. 1166 (2004).

9 *See* this report, *supra*, Most Litigated Issue, *Family Status Issues*.

10 Tax Reduction Act of 1975, S. Rep. No. 94-36 (1975).

11 Center on Budget and Policy Priorities: *A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2003*, May 2003, 1.

poverty than any other government program.[12] Unlike most other credits, the EITC can generate a refund above a taxpayer's actual liability. In 2003, 21.3 million taxpayers claimed $36.9 billion in credits.[13]

EITC Eligibility Requirements

Working taxpayers can qualify for the credit in one of two ways - either with a "qualifying child"[14] or by "income-only."[15] For tax year 2003, the amount of EITC that could be claimed by a taxpayer with a qualifying child or children ranged from $4 to $4,204, and from $1 to $382 for taxpayers qualifying under the "income-only" rules.[16] Both groups must meet general eligibility requirements.[17] To qualify for the child-EITC, the child for whom the taxpayer is claiming the credit must meet additional requirements.[18] Other provisions address the question of who receives the EITC when more than one taxpayer claims the same child.[19] Individuals claiming the income-only EITC must also meet specific requirements and thresholds.[20]

ANALYSIS OF LITIGATED CASES

Between June 1, 2003, and May 31, 2004, 28 cases were litigated in the Federal courts to determine EITC eligibility or refundability.[21] See Table 9 in Appendix 2, which categorizes the cases by taxpayer, issues, and other relevant data. The cases fall into six categories: (1) Residency Requirements for the EITC With Qualifying Child; (2) Relationship Requirements for the EITC With Qualifying Child; (3) Married Person Filing Status for the EITC; (4) Other EITC Eligibility Issues; (5) Administrative/Procedural Issues; and (6) Bankruptcy Issues.

[12] Center on Budget and Policy Priorities: *A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2003*, May 2003, 1.

[13] IRS, *2003 Data Book*, Table 5, 12. The *2003 Data Book* provides information for the fiscal year covering 10/01/02 through 9/30/03.

[14] IRC § 32(c)(3). All references in this section are to the Internal Revenue Code as in effect in 2004. Many of the references were changed by the WFTRA. While the WFTRA generally does not affect the eligibility of taxpayers for the EITC, it does change many of the references here.

[15] IRC § 32(c)(1)(A)(ii).

[16] IRS, *Earned Income Credit (EIC) 2003*, Publication 596, 40-44 (Rev. 2003).

[17] These include earned income (IRC § 32(c)(2)); income limitations (IRC § 32(a)(2)); citizenship or residence (IRC § 32(c)(1)(D) and (E); joint return, if married (IRC § 32(d)); requirement for a tax identification number (TIN) IRC § 32(c)(1)(F)(i); and investment income limitation (IRC § 32(i)). The taxpayer claiming the credit cannot be the qualifying child of another taxpayer (IRC § 32(c)(1)(B)).

[18] For 2004 and earlier years, these include relationship test (IRC § 32(c)(3)(A) and (B); residency (IRC § 32(c)(3)(A)(ii)); "principal place of abode;" and age requirements (IRC § 32(c)(3)(A) and (C).

[19] IRC § 32(c)(1)(C).

[20] These include residency (IRC § 32(c)(1)(A)(ii)(I)); age (IRC § 32(c)(1)(A)(ii)(II)); and the taxpayer cannot be a dependent of another taxpayer in the same year (IRC § 32(c)(1)(A)(ii)(III)).

[21] The opinion in *Mbanu v. Comm'r*, T.C. Summ. Op. 2004-58, was published but later withdrawn by the court. It is included here because the EITC issue went to trial.

Residency Requirements for the EITC With Qualifying Children

Seven cases, or 25 percent of all those litigated, concerned the residency requirements that must be met to claim the EITC.[22] All seven taxpayers represented themselves, *pro se*, and most had difficulty presenting credible evidence about facts necessary to prove the relevant requirements. In five cases, where the taxpayers did not prove the children resided with them for more than one-half of the year, legal counsel potentially could have assisted the taxpayers in developing relevant facts.[23] In three cases, the taxpayer was the non-custodial parent and could not prove the children lived with him for more than half the year.[24] By contrast, in *Kennedy v. Commissioner*, while holding against the taxpayer, the United States Tax Court demonstrated the scope of evidence that can be considered to determine EITC eligibility when the judge used the divorced parents' work calendars to determine with whom the children resided for more than one-half of the year.[25] Similarly, in *Hernandez v. Commissioner*, involving never-married parents, the court looked to the child's school records to determine the address used as the principal place of abode, and held that the taxpayer could not prove that his son lived with him for over one-half of the year.[26]

Several EITC cases also contained other family status tax issues that illustrate the tax law complexity that taxpayers face when applying different rules and definitions to similar family status situations. For example, in *Cantrell v. Commissioner*, the mother was allowed the EITC as well as the head of household filing status but was denied a dependency exemption and the child tax credit.[27] While the mother failed the support test necessary for the dependency exemption because child support payments and Section 8 subsidy payments made up more than half the support provided to the children, she was granted the EITC because she shared the same principal place of abode with her children.[28]

Relationship Requirements for the EITC with Qualifying Children

All seven cases involving relationship requirements concerned taxpayers claiming children not their own for purposes of the EITC. Because the EITC relationship rules were nar-

[22] *Cantrell v. Comm'r*, T.C. Summ. Op. 2004-52; *Hernandez v. Comm'r*, T.C. Summ. Op. 2003-144; *Taylor v. Comm'r*, T.C. Summ. Op. 2003-133; *Kennedy v. Comm'r*, T.C. Summ. Op. 2003-121; *Hamilton v. Comm'r*, T.C. Summ. Op. 2003-85; *Thompson v. Comm'r*, T.C. Summ. Op. 2003-73; *Linton v. Comm'r*, T.C. Memo 2003-160.

[23] *Hernandez v. Comm'r*, T.C. Summ. Op. 2003-144; *Taylor v. Comm'r*, T.C. Summ. Op. 2003-133; *Kennedy v. Comm'r*, T.C. Summ. Op. 2003-121; *Thompson v. Comm'r*, T.C. Summ. Op. 2003-73; *Linton v. Comm'r*, T.C. Memo 2003-160.

[24] *Taylor v. Comm'r*, T.C. Summ. Op. 2003-133; *Hamilton v. Comm'r*, T.C. Summ. Op. 2003-85; *Thompson v. Comm'r*, T.C. Summ. Op. 2003-73.

[25] *Cantrell v. Commissioner* ,T.C. Summ. Op. 2004-52.

[26] *Hernandez v. Commissioner*, T.C. Summ. Op. 2003-144.

[27] *Cantrell v. Commissioner*, T.C. Summ. Op. 2004-52.

[28] *Id.*

rower than those for claiming a child as a dependent, some taxpayers became involved in disputes over whether they had relationships with the children sufficient to claim the EITC. Four litigants claimed friends' children as dependents,[29] including two who claimed they had common-law marriages with the children's mothers under state law and could thus treat the children as stepchildren. Two others claimed nieces and nephews.[30] In two cases, unmarried taxpayers who lived with mothers and their children (by other men) claimed the EITC (as well as head of household filing status) based on the argument that the children were foster children who they cared for as their own.[31] Both arguments were rejected by the Tax Court based on analysis of state law.[32] One taxpayer argued that the children qualified as foster children, but this argument was rejected because they were not placed with him by an authorized agency.[33]

In *Gilmore v. Commissioner*, the Tax Court ruled that the taxpayer (who lived with his mother, sister, his sister's two children, and his brother) qualified for the EITC because he proved he cared for his nieces as his own even though the children's grandmother also lived in the home and worked.[34] By contrast, the court in *Brinson v. Commissioner* held that it was not willing to assume that the taxpayer cared for his niece and nephew since technically a probate court order had made the children the responsibility of taxpayer's parents with whom the taxpayer lived.[35] The different results in the two cases demonstrate the difficulty for taxpayers in non-traditional family situations in determining their tax status with any certainty.

Married Person Filing Status for the EITC

Married taxpayers must file a joint tax return to be eligible for the EITC and cannot use the Married Filing Separately Filing status (MFS).[36] A taxpayer not living with his or her spouse for more than the last six months of the year may be considered not married for tax purposes if the taxpayer maintains as his or her home a household which constitutes

[29] *Carter v. Comm'r*, T.C Summ. Op. 2004-18; *Echevarria v. Comm'r* , T.C. Summ. Op. 2003-92; *Elliott v. Comm'r*, 2003-106; *Webb-Reed v. Comm'r*, T.C. Summ. Op. 2004-6.

[30] *Gilmore v. Comm'r*, T.C. Summ. Op. 2004-38; *Brinson v. Comm'r*, T.C. Summ. Op. 2003-89.

[31] *Elliot v. Comm'r*, T.C Summ. Op. 2003-106; *Carter v. Comm'r*, T.C Summ. Op. 2004-18; *Echeverria v. Comm'r*, T.C. Summ. Op. 2003-92. Note that this test was amended by WFTRA and will be replaced in 2005 by a more objective legal placement test.

[32] *Carter v. Comm'r*, T.C. Summ. Op. 2004-18, *Elliott v. Comm'r*, T.C. Summ. Op. 2003-106.

[33] *Echevarria v. Comm'r*, T.C. Summ. Op. 2003-92.

[34] *Gilmore v. Comm'r*, T.C. Summ. Op. 2004-38. The Tax Court held that the taxpayer was not entitled to the dependency exemption for his nieces because the taxpayer did not prove that he provided over one-half of the necessary support and consequently was denied the IRC § 2 head of household filing status because dependency under IRC § 151 was a precondition to the head of household filing status. The taxpayer was also denied the IRC § 24 child tax credits because of the precondition of dependency.

[35] *Brinson v. Comm'r* , T.C. Summ. Op. 2003-89.

[36] IRC § 32(d).

the principal place of abode for a child for more than one-half of the taxable year.[37] Taxpayers who can demonstrate these requirements may be able to both claim head of household filing status and be eligible for the EITC.[38]

In five cases, married taxpayers claimed head of household filing status, but in all five instances the court found that the proper filing status was MFS and denied the EITC.[39] Only in the bankruptcy case did the taxpayer have the assistance of an attorney.[40] In that case, a married couple in bankruptcy argued they were separated for the majority of the year, and as a result both husband and wife were entitled to EITC and head of household filing status. The taxpayers were unable to prove their case, as it appeared they lived together during the last six months of the year, were married, and did not maintain separate households for more than one-half of the year.[41]

In *Ahmed v. Commissioner*, the taxpayer argued that he was unmarried for purposes of EITC eligibility because his wife was a nonresident alien (under IRC § 2(b)(2)(C) certain taxpayers with nonresident alien spouses are considered unmarried).[42] However, the Tax Court ruled the taxpayer's spouse was a resident of the United States under the "substantial presence test," and accordingly, the taxpayer was married for tax purposes and therefore not entitled to either the EITC or the head of household filing status. In *Elsawah v. Commissioner*, the taxpayer argued that even though he was married and did not file a joint return he should be considered unmarried for tax purposes.[43] The taxpayer claimed he and his wife were separated for purposes of IRC § 7703, because they obtained an Islamic divorce and were living separately in the same house. The Tax Court disregarded the impact of the Islamic divorce on the parties' relationship and held that because they lived under one roof they resided in the same household and therefore could not be considered "separated" for IRC § 7703 purposes.

It is unclear whether all the taxpayers' problems could have been resolved by the filing of joint returns or whether there were cases in which both husband and wife were trying to claim the same EITC by stating they were not married or legally separated. These cases demonstrate the challenges that low income taxpayers with non-traditional living arrangements and cultural differences must face in comprehending the federal tax laws and terminology and accurately filing their returns.

[37] IRC § 7703(b).

[38] IRC § 2(b).

[39] *Gallardo v. Comm'r*, T. C. Summ. Op. 2004-72; *Mbanu v. Comm'r*, T.C. Summ. Op. 2004-58; *Elsawah v. Comm'r*, T.C. Summ. Op. 2004-33; *Ahmed v. Comm'r*, T.C. Summ. Op. 2004-20; *St. Hilaire v. Comm'r*, T.C. Summ. Op. 2003-102.

[40] In *re Broadus*, 93 A.F.T.R. 2d 2004 (RIA) 1972 (Bankr. D. Colo.).

[41] *Id*.

[42] *Ahmed v. Comm'r*, T.C. Summ.Op. 2004-20.

[43] *Elsawah v. Comm'r*, T.C. Summ. Op. 2004-33.

Other EITC Eligibility Issues

In addition to the residency rules, relationship rules, and age rules for EITC eligibility, taxpayers with qualifying children must also satisfy rules relating to adjusted gross income and identification numbers. For example, the taxpayers in two cases proved that their children qualified based on relationship, residency, and age tests, but because the children were also qualifying children of other individuals and the litigants could not prove they had higher adjusted gross income than the other individuals, they were not able to claim the credit.[44] In *Betancourt v. Commissioner*, the Tax Court held that the living arrangements, where one parent and two children allegedly lived in one half of a duplex while the other parent and one child lived in the other half, constituted a single principal place of abode and, accordingly, each parent satisfied the residency and relationship test and the children were qualifying for both parents.[45] However, the individual with the highest adjusted gross income was the children's mother and the father was denied the EITC.

In *Cisse v. Commissioner*, the taxpayer claimed that his nephew was a qualifying child. However, the nephew (who was a resident alien) had a Social Security card stamped "NOT VALID FOR EMPLOYMENT."[46] The identification requirement in IRC § 32(c)(3)(D)(i) provides that a child will not be considered a qualifying child unless his or her name, age and Taxpayer Identification Number (TIN) are provided on the return in question. The Tax Court ruled that the term TIN references the number issued to those entitled to engage in employment in the United States and denied the EITC for reasons other than residency and support.

Administrative/Procedural Issues

Three cases involved procedural issues relating to refunds generated by the EITC.[47] In one case, the Court of Appeals upheld a district court decision rejecting a refund claim arising from EITC claimed on returns filed over five years late. The court held that the EITC was a payment of taxes and therefore subject to the three year statutory period for making refund claims under IRC § 6511(b).[48]

Disposition of the EITC in Bankruptcy

In addition to substantive disputes concerning eligibility for the EITC, there is continuing litigation in the U.S. bankruptcy court concerning whether EITC is income for purposes of determining payment arrangements or whether a refund arising from the EITC is exempt from the claim of creditors. The Internal Revenue Service is usually not a party to these disputes, whose resolution often depends on state law. For example, while the EITC

[44] *Betancourt v. Comm'r*, T.C. Summ. Op. 2004-61; *Francisco v. Comm'r*, T.C. Summ. Op. 2004-4.

[45] *Betancourt v. Comm'r*, T.C. Summ. Op. 2004-61.

[46] *Cisse v. Comm'r*, T.C. Summ. Op. 2003-143.

[47] *Israel v. United States*, 356 F.3d 221 (2nd Cir. 2004); *Favret v. United States*, 92 A.F.T.R. 2d (RIA) 7249 (E.D. La. 2003); *Voigt v. Comm'r*, T.C. Memo. 2004-62.

[48] *Israel v. United States*, 356 F. 3d 221 (2nd Cir. 2004).

is "exempt property", it can be used, like other exempt property, in calculating disposable income for purposes of Chapter 13 payment plans.[49] On the other hand, in most states EITC refunds are exempt from creditors and the debtors are able to keep that part of the refund resulting from EITC.[50]

Receipt of the EITC by debtors was an issue in a number of cases involving hardship discharges of student loan debts. While such cases are decided under the individual facts and circumstances, bankruptcy court judges have generally held that receipt of the EITC will not impede such discharges.[51]

Representation by Legal Counsel

Of the 28 EITC cases tried, the taxpayers represented themselves, *pro se*, in 22 cases (79 percent) and had the assistance of attorneys in the remaining six cases (21 percent). An analysis of the resulting decisions is depicted in Table 3.9.1 below. The taxpayers had representation in both bankruptcy-related cases and in two of the three administrative/procedural cases, but in only two cases involving EITC eligibility issues. One of these cases also involved seeking litigation costs. Of the 22 *pro se* cases, the government prevailed in 16 and the remaining six resulted in split decisions, where both the taxpayer and the government prevailed on certain issues.

TABLE 3.9.1, DECISIONS IN EITC CASES, *PRO SE* VS. REPRESENTATION

	Pro Se		Attorney	
For IRS/Government	16	73%	5	83%
For Taxpayer	0	0%	1	17%
Split Decision	6	27%	0	0%
Total Cases	22	100%	6	100%

CONCLUSION

The analysis above shows how difficult and complicated the EITC eligibility rules have become for both taxpayers and the IRS. This complexity causes taxpayers (and IRS employees) to make errors while attempting to interpret and apply the tax laws to their individual situations. There are of course EITC cases that are litigated due to legitimate interpretive and factual disputes. However, this analysis makes it clear that too many low

[49] In *re Sohn* , 300 B.R. 332 (D. Minn. 2003).

[50] In *re Walsh* , 298 B.R. 894 (D. Colo. 2003).

[51] *Alston v. U.S. Dept.of Educ.*, 297 B.R. 410 (Bankr. E.D. Pa. 2003). 2003); In *re Pollard*, 306 B.R. 637 (Bankr. D. Minn. 2004); *Warner v. Educ. Credit Mgmt. Corp.* 296 B.R. 501 (Bankr. D. Neb. 2003).

income taxpayers struggle to determine EITC eligibility. Many of the findings confirm the problems that prior Annual Reports to Congress and recent legislative changes are attempting to address.[52]

[52] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003), 152-162; National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), 47-94; National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2001), 76; The Working Families Tax Relief Act, Pub. L. No. 108-311, § 201, 118 Stat. 1166 (2004), provides a uniform definition of "qualifying child" to be used for 5 provisions (dependency exemption, child credit, earned income tax credit, the dependent care credit and the head of household filing status).

LITIGATED ISSUE #10 MOST LITIGATED ISSUE: TRUST FUND RECOVERY PENALTY

SUMMARY

Twenty-six cases involving the Trust Fund Recovery Penalty (TFRP) were litigated in the Federal courts between June 1, 2003 and May 31, 2004. The IRS prevailed in 18 cases, the taxpayer prevailed in five, and the remaining three cases resulted in split decisions.

Internal Revenue Code § 6672 imposes the TFRP against persons who fail to withhold and pay over trust fund taxes to the IRS.[1] The penalty is equal to the amount of the tax that is required to be collected or is collected, and is not paid over.[2]

To be liable for the TFRP under IRC § 6672, a person[3] must be responsible for collecting, or accounting for and paying over, the trust fund tax ("responsibility"), and must have willfully failed to do so ("willfulness"). The responsibility and willfulness requirements are the primary issues litigated regarding the Trust Fund Recovery Penalty. Taxpayers continue to challenge the IRS's determinations as to who, by virtue of their position or authority, was responsible for ensuring the trust fund taxes were paid. Further, issues continue to arise as to when taxpayers have willfully failed to pay this money to the government.

Table 10 in Appendix 2 presents a breakdown of these cases, including the issue litigated, whether the taxpayer was represented by counsel, and how the court decided each case.

PRESENT LAW

Internal Revenue Code § 6672 imposes a penalty on any person required to collect, truthfully account for, and pay over any tax imposed under the Code where that person willfully fails to do so, or willfully attempts to evade tax. The TFRP is often referred to as the 100 percent penalty because the amount is equal to 100 percent of the trust fund taxes evaded, not collected, or not accounted for and paid over.[4] Trust fund taxes are those Federal taxes that are required to be collected or withheld, accounted for, and paid over to the government, such as employment taxes and certain types of excise taxes.

1 Trust fund taxes are monies withheld by an employer from an employee's wages and held in trust until paid over to the government. IRC § 7501.

2 IRC § 6672.

3 Throughout this piece, the term "person" or "taxpayer" refers to a responsible person as defined for purposes of the TFRP.

4 IRC § 6672.

5 IRC § 3102(a) requires the withholding of FICA taxes imposed by IRC § 3101. FICA includes both Social Security (Old age, survivors, and disability insurance) imposed by IRC § 3101(a) and Medicare (Hospital insurance) imposed by IRC § 3101(b).

For example, employers are required to withhold the following taxes from employees' wages:

- Federal Insurance Contribution Act Tax (FICA),[5]
- Federal Income Tax,[6] and
- Railroad Retirement Tax.[7]

In addition, businesses are required to collect the following excise taxes from their customers:

- Communications services tax,[8]
- Airline transportation tax (on persons),[9] and
- Airline transportation tax (on freight).[10]

Who is a responsible person?

A "person" for purposes of the TFRP includes (but is not limited to) an officer or employee of a corporation or a member or employee of a partnership who is under a duty to perform the act for which the IRS seeks to impose the TFRP.[11] Neither the Internal Revenue Code nor any Treasury Regulation defines the term "responsible person." Courts have used the term over the years to describe a person[12] required to collect, truthfully account for, or pay over trust fund taxes.[13]

The determination of "responsibility" is based on the facts and circumstances in each case, but the following factors[14] are often considered in identifying a responsible person: (1) status as an officer, director or shareholder; (2) management of day-to-day business operations; (3) authority to hire and fire employees; (4) authority to borrow money; (5) authority to decide which creditors to pay and in what order; and (6) authority to sign checks. While no single factor is controlling, most courts have concluded that a person is "responsible" for purposes of the TFRP if the person has significant control over a company's finances.[15]

---

[6] IRC § 3402(a).

[7] IRC § 3202 requires the withholding of the Railroad Retirement Act Tax imposed by IRC § 3201.

[8] IRC § 4251.

[9] IRC § 4261.

[10] IRC § 4271.

[11] IRC § 6671(b).

[12] The term "responsible person" is not limited to individuals and is broad enough to include corporations and other artificial entities. *See Pacific Nat'l Ins. Co. v. United States*, 422 F.2d 26, 30 (9th Cir. 1970).

[13] *Slodov v. United States*, 436 U.S. 238, 246 n.7 (1978).

[14] *See*, e.g., *Lyon v. United States*, 92 A.F.T.R.2d (RIA) 5029 (4th Cir. 2003); In re Groth, 92 A.F.T.R.2d (RIA) 6318 (Bankr. D.N.D. 2003); United States v. Schock, 92 A.F.T.R.2d (RIA) 5162 (D. Del. 2003).

[15] *See*, e.g., Denbo v. United States, 988 F.2d 1029, 1032 (10th Cir. 1993) (citations omitted); *Brounstein v. United States*, 979 F.2d 952, 954 (3rd Cir. 1992) (citation omitted).

A penalty will not be imposed on any unpaid, volunteer member of any board of trustees or directors of a tax-exempt organization if that member

- Is serving solely in an honorary capacity,
- Does not participate in the day-to-day or financial operations of the organization, and
- Does not have actual knowledge of the failure on which the penalty is imposed.[16]

More than one person may be a responsible person with respect to the same business entity's unpaid trust fund taxes, with each such person being jointly and severally liable for the TFRP.[17] While there can be multiple responsible persons in any given case, the IRS will collect the withheld income and employment taxes or collected excise taxes only once,[18] whether from the business, from one or more of its responsible persons, or from the business and one or more of its responsible persons. Thus, the IRS uses the TFRP as a collection mechanism for the underlying unpaid trust fund taxes.

Willfulness

Willfulness for purposes of IRC § 6672 generally means a voluntary, conscious, and intentional decision not to turn over trust fund taxes to the United States.[19] One of three general standards may be used to show that a responsible person has acted willfully:

(1) *Deliberate choice* - willfulness exists where a responsible person makes a deliberate choice to pay other creditors instead of paying trust fund taxes over to the United States.

(2) *Knowledge* - willfulness exists where a responsible person knows that trust fund taxes have not been paid and continues to permit the company to pay other creditors.

(3) *Reckless disregard* - willfulness exists where a responsible person acts with a reckless disregard of a known or obvious risk that trust fund taxes will not be paid over to the United States, including failing to investigate or correct mismanagement after being notified that trust fund taxes have not been properly paid over.

[16] IRC § 6672(e). This exemption does not apply if it results in no person being liable for the penalty under § 6672.

[17] *Brown v. United States*, 591 F.2d 1136 (5th Cir. 1979).

[18] *See* Policy Statement P-5-60, IRM 1.2.1.5.14(1).

[19] *See*, e.g., *Bell v. United States*, 355 F.3d 387, 393 (6th Cir. 2004) (quotation omitted).

Notice Requirement

Under IRC § 6672(b)(1), no penalty can be assessed unless the taxpayer is notified in writing[20] or in person that the taxpayer shall be subject to the penalty. The notice must be delivered to the taxpayer at least 60 days before any notice and demand of the penalty can be made.[21] This notice requirement does not apply if collection of the penalty is in jeopardy.[22]

Extension of period of collection

The period of collection[23] can be extended if, within 30 days after the day on which notice and demand of the TFRP is made against any person, such person:

- Pays an amount that is not less than the minimum required to commence a proceeding in court with respect to his liability for such penalty,
- Files a claim for refund for the amount so paid, and
- Furnishes a bond which meets the requirements of IRC § 6672(c)(3).[24]

If the period for collection is extended, the IRS cannot begin to collect the remaining penalty until the claim for refund reaches a final resolution.[25]

If more than one person is liable for the penalty, each person who paid the penalty is entitled to recover from others who are also liable. The amount of recovery is the excess of the amount paid by the responsible person over their proportionate share of the penalty. Any claim for recovery may only be made in a separate proceeding from an action for collection of the penalty brought by the United States, or a proceeding in which the United States files a counterclaim or third-party complaint for the collection of such a penalty.[26]

Upon request in writing by a person liable for the TFRP, the Secretary of the Treasury shall disclose the name of any other person determined to be liable for the TFRP with respect to the same failure, whether an attempt has been made to collect the penalty from the other person, the general nature of the collection activities, and the amount collected.[27]

---

[20] The written notification must be sent to the taxpayer's address in accordance with IRC § 6212(b).

[21] If the notice is delivered before the expiration of the period of assessment for the penalty provided by IRC § 6501, the period provided for the assessment of the penalty shall not expire before the later of the date 90 days after the date on which the notice was mailed or delivered in person, or if there is a timely protest of the proposed assessment, the date 30 days after the Secretary makes a final administrative determination with respect to the protest. IRC § 6672(b)(3).

[22] IRC § 6672(b)(4).

[23] The IRS must assess the TFRP within three years after a return is filed. See IRC § 6501(a). After assessment, the IRS has 10 years in which to begin collection by levy or court proceeding. See IRC § 6502(a).

[24] IRC § 6672(c)(1).

[25] IRC § 6672(c)(1).

[26] IRC § 6672(d).

[27] IRC § 6103(e)(9).

Who has the burden of proof in a TFRP case?

Generally, the burden is on the taxpayer to show that the proposed determination made by the Commissioner of Internal Revenue is incorrect. In a court proceeding, once the IRS introduces a TFRP assessment into evidence, the taxpayer has the burden of proof.[28]

ANALYSIS OF LITIGATED CASES

Twenty-six cases involving the trust fund recovery penalty were litigated in the Federal court system from June 1, 2003 through May 31, 2004.[29] A detailed listing of the cases can be found in Table 10 in Appendix 2.

The IRS prevailed in 18 cases, the taxpayers prevailed in five, and the remaining three cases resulted in split decisions. The taxpayers had legal representation in 23 of the 26 cases. Those who were represented prevailed in four cases and were involved in three split decisions, while the IRS prevailed in the other 16 cases. Taxpayers operated as their own legal counsel, *pro se*, in three cases. One *pro se* taxpayer prevailed, and the IRS prevailed in the remaining two cases.

The focus of TFRP litigation falls on the responsibility and willfulness determinations that must be made before an individual is assessed the penalty. These types of cases constituted 22 of 26 (almost 85 percent) of those litigated in the period covered by our review. The IRS prevailed in 14 of the 22 cases; the taxpayer prevailed in five, and there were split decisions in three cases.

Although a number of Trust Fund Recovery Penalty cases were litigated during the past year, this does not necessarily indicate complexity in IRC § 6672 or confusion over its application. By its nature, the application of the TFRP is a fact-based decision, dependent on whether the taxpayer was a responsible person and whether he or she willfully failed to pay the necessary taxes owed.[30] The courts have defined what it means to be “responsible” and to act “willfully.” These definitions, however, are dependent on the facts and circumstances of each case. It is likely that a significant number of cases involving this issue will continue to be litigated as parties try to avoid the penalty.

[28] While in certain tax matters, a taxpayer can introduce credible evidence to shift the burden to the Commissioner, the burden cannot be shifted in a TFRP case. See IRC § 7491(a)(1) (applicable only for taxes arising under subtitles A or B, whereas the taxes attributable to the TFRP arise under subtitles C and D).

[29] Trust fund recovery penalty cases are generally in the nature of a suit for refund. A taxpayer must first file an administrative claim for refund and at least pay in full the tax liability attributable to one employee for one quarter. IRC § 7422(a); *Steele v. U.S.*, 280 F.2d 89, 90 (8th Cir. 1960) (citing *Flora v. U.S.*, 362 U.S. 145, 175 fn. 37 (1960)). The administrative claim must either be denied or six months pass before the taxpayer can file a suit in either the appropriate Federal district court or the United States Claims Court. IRC § 6532(a)(1). The taxpayer may elect to have a jury trial of the refund claim in the Federal district court. None of the cases litigated from June 1, 2003 through May 31, 2004 were jury trials.

[30] IRC § 6672.

CONCLUSION

Internal Revenue Code § 6672 imposes a 100 percent penalty on certain taxpayers who fail to withhold and pay over trust fund taxes. The determination as to who is subject to the penalty is fact-based and continues to be the subject of litigation. Congress has recently considered a possible amendment to IRC § 6672 that would include payroll agents among those liable for the TFRP.[31] If this change is made, it will likely lead to increased litigation from a new class of taxpayers.

[31] H.R. 158, 108th Cong. § 154 (2004).

INTRODUCTION

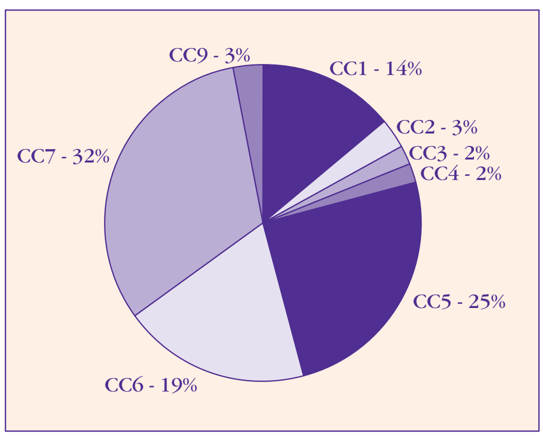
The complexity of our nation's tax code creates a moving target: an ever-changing array of issues and challenges for taxpayers, IRS employees, and the Taxpayer Advocate Service (TAS). In the past year, TAS has integrated its case advocacy and systemic advocacy roles, bringing a frontline field perspective to the discussion of national issues and enhancing our awareness of problems on IRS campuses and elsewhere in the field. In all of our work, we independently analyze problems, impartially evaluate the facts and circumstances, and maintain appropriate confidentiality. These principles have guided TAS from the start and remain our standard for addressing both systemic issues and individual cases.

CASE ADVOCACY

Case Receipts

Internal Revenue Code section 7811(a) defines the types of hardships that taxpayers might experience which meet the criteria for TAS intervention. These definitions align themselves into two broad categories of problems: 1) economic or financial, and 2) procedural or systemic. TAS received 168,856 cases in FY 2004.[1] Chart 4.1 illustrates these receipts by Criteria Code (CC):

CHART 4.1, FY 2004 TAS CASE RECEIPTS BY CRITERIA



[1] TAS received 164,035 cases that originated as Applications for Taxpayer Assistance Orders (TAS Criteria Codes 1 through 7). TAS received 4,821 cases that originated from other sources.

TAS CRITERIA CODES

Financial or Economic Hardship

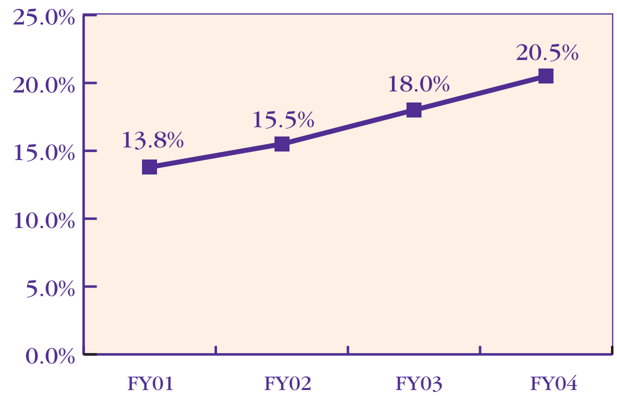
Criteria Code	Description	% of Cases
CC 1	Taxpayer suffering or about to suffer a significant hardship (IRC §7811(a)(1)(A))	14
CC 2	Taxpayer facing threat of adverse action (IRC §7811(a)(2)(A))	3
CC 3	Taxpayer will incur significant costs if relief is not granted (IRC §7811(a)(2)(C))	2
CC 4	Taxpayer will suffer irreparable injury, or long term adverse impact (IRC §7811(a)(2)(D))	2

Systemic or Procedural Hardship

Criteria Code	Description	% of Cases
CC 5	Taxpayer experienced a delay of more than 30 days to resolve tax account problem (IRC §7811(a)(2)(B))	25
CC 6	Taxpayer has not received a response by the date promised	19
CC 7	A system(s) or procedure(s) has failed to operate as intended or failed to resolve the taxpayer's problem	32
CC 9	Local Taxpayer Advocate has determined it is in the best interest of the taxpayer for TAS to be involved	3

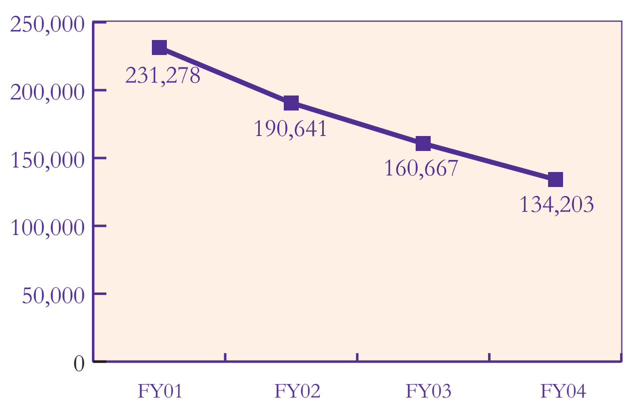
Most taxpayers contact TAS because they are experiencing systemic or procedural hardships caused by the Internal Revenue Service. Seventy-nine percent of our new case receipts met this category while the remaining 21 percent were the result of economic or financial situations. The percentage of economic or financial hardship cases has risen each year -- from 15.5 percent in FY 2002 and 18 percent in FY 2003. We expect the trend in economic case receipts to continue because of the increase in IRS enforcement and compliance initiatives. Chart 4.2 illustrates how the composition of TAS casework has changed over the last four fiscal years.

CHART 4.2, TAS ECONOMIC HARDSHIP CASE RECEIPTS AS A PERCENTAGE OF TOTAL SIGNIFICANT HARDSHIP CASE RECEIPTS



While TAS economic hardship receipts have remained relatively level, we continue to experience a significant decrease in cases resulting from systemic hardships. These cases involve taxpayers undergoing delays of more than 30 days to resolve tax account problems, not receiving responses by the date promised, and system(s) or procedure(s) failing to operate as intended or failing to resolve the taxpayer's problem. Chart 4.3 illustrates how systemic hardship cases have declined over the last four fiscal years.

CHART 4.3, SYSTEMIC HARDSHIP CASE RECEIPTS



On the surface, the decline appears to show that fewer taxpayers require TAS assistance to resolve systemic problems with the IRS. TAS is concerned that the decrease is not only attributable to IRS improvements, but also to taxpayers lacking knowledge of or access to

TAS. In response to these concerns, TAS has undertaken several initiatives to promote awareness and access to TAS, which are discussed in greater detail in the Most Serious Problem *Access to the Taxpayer Advocate Service*.

Sources of TAS Casework

TAS enhanced its management information system in April of 2003, expanding the former major issue codes in both specificity and the number of identifiable issues.[2] The data in this report is the result of this enhancement. Table 4.4 illustrates the top ten case issues received in TAS this fiscal year.

TABLE 4.4, TOP TEN ISSUES RECEIVED IN TAS IN FY 2004

Rank	Description of Issue	Cases
1	Criminal Investigation	16,460
2	Processing Amended Returns	11,180
3	EITC - Revenue Protection Strategy Examinations	10,179
4	Levies (including the Federal Payment Levy Program)	8,857
5	Processing Original Tax Returns	8,493
6	Expedite Refund Requests	7,158
7	Audit Reconsiderations	7,131
8	Injured Spouse Claims	6,129
9	Open Examinations - Non EITC	4,773
10	Underreporter Process Reconsiderations	4,563
	Total	**84,923**

Trends in TAS Case Receipts

Since the Taxpayer Advocate Service organization "stood up" more than four years ago, the typical TAS case has changed from a simple service problem (most likely associated with filing returns and obtaining refunds) to a more complex compliance-related case which includes several years of accumulated tax debt and related tax administration issues.[3]

Criminal Investigation Cases

Cases involving Criminal Investigation (CI) freezes on taxpayer accounts made up the largest portion of TAS receipts in FY 2004. Over 16,400 taxpayers contacted TAS because the IRS held their refunds or failed to process their returns, up from 15,118 in FY 2003. More than half of these cases (over 8,700) resulted from the IRS failing to respond to the taxpayer by the date promised in an earlier contact. This number is disturbing, consider-

[2] TAMIS enhancement in April 2003 expanded the number of issue codes from 54 to 124. These codes are used to identify the major issue of a TAS case.

[3] See Table 1.21.4 in Most Serious Problem, *Access to the Taxpayer Advocate Service*, supra.

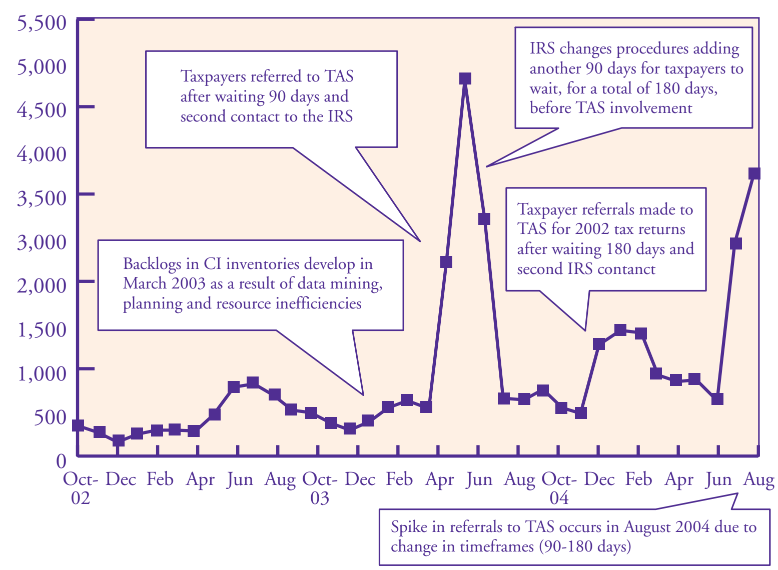
ing that in FY 2003 the IRS added 90 days to the response timeframe given to taxpayers.

The CI function administers this program, and each of the 10 IRS processing campuses has a fraud detection center. The IRS suspends the issuance of refunds while CI reviews suspect returns. If the income and tax withholding are verified, the refund is released and issued to the taxpayer. If the withholding is not verified as accurate, CI will either reverse out the refund on the account, refer the case to a CI Special Agent to pursue as a criminal case, or refer the account to the Examination function for audit. Where the return is verified as accurate, TAS has been successful in obtaining expedited refunds to taxpayers experiencing financial or economic hardships. Some notable facts about the TAS CI cases include:

- The number of taxpayers requiring TAS assistance has jumped from 5,585 in FY 2002 to 16,460 in FY 2004, a 195 percent increase.
- The majority (92.2 percent) of the TAS CI case receipts begin as referrals to TAS from the IRS Account Management organization. These taxpayers attempted to resolve their cases through normal processes but were unsuccessful.
- TAS provided relief in almost 50 percent of the cases received in FY 2004.

Chart 4.5 highlights the cause and effect that IRS programs can have on taxpayers and TAS case receipts.

CHART 4.5, CAUSE AND EFFECT, TAS CRIMINAL INVESTIGATION CASES



Earned Income Tax Credit Cases

The largest decline in TAS case receipts (49.8 percent) involved Earned Income Tax Credit (EITC) examinations. TAS received 10,179 new EITC examination cases in FY 2004 compared to 20,266 in FY 2003. TAS has dedicated significant time and effort in both case and systemic advocacy to improving the EITC program. Some noteworthy steps that have reduced the number of EITC taxpayers seeking TAS assistance include:

- Implementation of the automated batch processing system;
- Increased EITC staffing;
- Testing new documentation requirements;
- Changing internal IRS procedures to hold only the amount of refund attributable to the EITC during the examination process;
- Improved mail handling processes;
- Enhanced training and clarified procedures for document requests;
- Improved communication and outreach efforts

Non-Response Audits

Each year, the IRS closes a significant portion of Earned Income Tax Credit (EITC) audit cases without receiving a taxpayer response. The IRS must presume that these taxpayers are ineligible for EITC and disallow the credit accordingly. Despite the lack of an initial response, these taxpayers often revisit the audit by contacting local Taxpayer Advocate Service offices and Low Income Tax Clinics. Additionally, some taxpayers have their original audit reviewed by Appeals, as a result of their petitioning the Tax Court. These requests for reconsideration of the original audit create additional burden for both the taxpayer and the IRS.

The Taxpayer Advocate's Office was asked to participate in a study being conducting by W&I Research to determine why these taxpayers never responded to the original audit. The study involved the completion of a brief check sheet designed to obtain the reason for the non-response to the original audit or what actions were taken if the taxpayer claimed a response to the audit was initiated. This study hopes to obtain data to reduce the EITC audit non-response rate, by gaining insight into how taxpayer responses are made, factors contributing to non-response and process changes which would have assisted taxpayers with a response.

Lien and Levy Cases

New cases resulting from lien and levy enforcements continued an upward trend. In FY 2004, TAS received 4,190 new cases where the notice of federal tax lien was the primary issue compared to 3,501 cases in the last fiscal year. In another 652 new cases, the notice of federal tax lien was the secondary issue. The total number of cases received in TAS with levy actions as the primary or secondary issue was 9,907; in 8,857 cases, the levy action itself was the primary issue.

Taxpayer Assistance Center Cases

The number of taxpayers coming to TAS to request copies of returns, forms, or transcripts increased by 41 percent (1,187 cases) compared to last fiscal year. This increase is a result of the elimination of a service previously provided by Taxpayer Assistance Centers (TACs). This problem was first highlighted in the 2003 Annual Report to Congress and is again discussed in this year's report.[4]

Downstream Effects of Compliance Initiatives

TAS is conducting a study to determine how Operating Division activities generate workload for TAS. We will coordinate our efforts with National Office Research and the Wage and Investment and Small Business/Self-Employed Research functions.

The analysis entails breaking down the TAS case workload into components and analyzing the relationship between each component and Operating Division workload/activities. In addition to on going activities, such as typical collection and examination activities, several new initiatives, including the Revenue Protection Strategy audits, Collection Due Process, and the Criminal Investigation Division Fraud Detection Program refund freezes will be studied to see if their impact changes over time as the Operating Divisions make adjustments to handle the new workload more effectively.

Case Closures

Taxpayer Advocate Service employees closed 170,672 cases this past fiscal year, 165,622 of which originated as Applications for a Taxpayer Assistance Order (ATAO) (Form 911 or acceptable substitute) in FY 2004 or in prior years.[5] The remaining closed cases (5,050) are those where taxpayers contacted TAS for assistance and TAS determined it to be in the taxpayer's best interest to open a case and resolve the issue.[6] TAS provided partial or full relief in 67.3 percent of cases received as ATAOs. Table 4.6 details the Application for Taxpayer Assistance Order (ATAO) cases closed in FY 2004.[7]

[4] See Most Serious Problem, *Access to Face-to-Face Interaction with the IRS*, supra.

[5] Applications for Taxpayer Assistance Order cases are TAS Criteria Code 1-7 cases.

[6] Best interest of the taxpayer cases are TAS Criteria Code 9 cases.

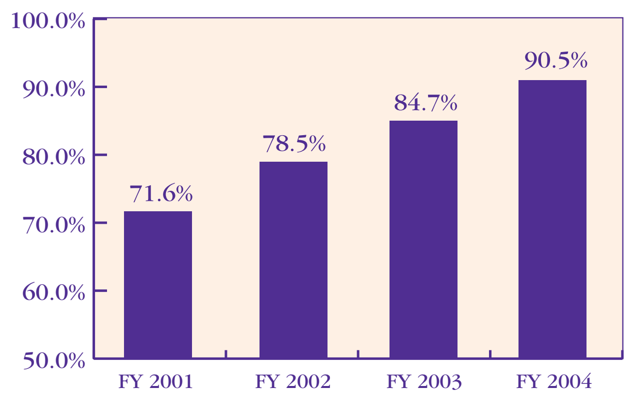
[7] The table does not include the case disposition on Criteria Code 9 cases. TAS provided assistance in 54 percent of the Criteria 9 case closures. One TAO remains open.

TABLE 4.6, APPLICATION FOR TAXPAYER ASSISTANCE ORDER CASE DISPOSITION

Type of Relief	Number	%
Total Applications for Taxpayer Assistance	**165,622**	**100.00%**
Taxpayer Assistance Order (TAO) issued	30	0.02%
Relief provided to taxpayer	**111,500**	**67.32%**
Full Relief	101,451	61.26%
Partial Relief	10,022	6.05%
Taxpayer Assistance Order (TAO) complied	23	0.01%
TAO sustained	1	0.00%
TAO modified	3	0.00%
No relief provided to taxpayer	**54,049**	**32.64%**
No response from taxpayer	20,143	12.16%
Advocate does not deem relief appropriate	18,007	10.87%
Relief provided prior to TAS relief determination	7,976	4.82%
Taxpayer rescinds ATAO, no longer requires TAS assistance	2,593	1.57%
Hardship not validated or documentation/verification that the Advocate deems necessary not provided by taxpayer	2,521	1.52%
Hardship did not involve the administration of internal revenue laws	1,495	0.90%
Advocate determined relief appropriate, but current law prevents granting relief	1,312	0.79%
TAO issued and rescinded by the Advocate	2	0.00%
Relief not identified	**73**	**0.04%**

Our business results demonstrate continuing improvement in case quality and the length of time needed to resolve the taxpayer's problem. Our overall case quality rate for FY 2004 improved to 90.5 percent from 84.7 percent for FY 2003. Chart 4.7 illustrates the steady improvement in TAS case quality over the last four fiscal years.

CHART 4.7, TAS CASE QUALITY FY 2001 THROUGH FY 2004[8]



[8] TAS uses eight standards to measure its case quality: Standard #1 – Initial taxpayer contact timely, Standard #2 – Initial actions timely, Standard #3 – Subsequent actions timely, Standard #4 – Complete and correct resolution of taxpayer's problem, Standard #5 – Addressing related issues, Standard #6 – All actions were technically/procedurally correct, Standard #7 – Clear, complete, correct explanation to taxpayer at closing, and Standard #8 – Educating the taxpayer.

Operations Assistance Requests (OARs)/Service Level Agreements (SLAs)

An Operations Assistance Request (OAR) is used by TAS to request assistance from an IRS operating division or function to complete an action on a TAS case. An OAR is necessary when TAS does not have the statutory or delegated authority to take the action(s) required to resolve the case. On October 1, 2003, TAS implemented the electronic Form 12412, Operations Assistance Request, on the Taxpayer Advocate Management information System (TAMIS). All OARs are now generated through TAMIS and the information is stored in the TAMIS database, which allows TAS to generate reports for operating and functional divisions (ODs and FDs). Table 4.8 highlights the number of OARs issued and closed in FY 2004 and the average age of the closed OARs.

TABLE 4.8, OAR ACTIVITY FY 2004

Operating Division/Function	OARs Issued	OARs Closed	Average Age (in Days)
Appeals	1,598	1,337	49.6
Criminal Investigation	17,435	15,585	19.7
Large/Mid-Size Business	137	128	35.5
Small Business/Self-Employed	52,827	49,901	19.2
Tax Exempt/Government Entities	556	515	25.9
Wage & Investment	51,181	48,570	18.8
Total	**123,734**	**116,036**	**19.5** [9]

TAS developed OAR reports for the four operating divisions, Appeals and Criminal Investigation in FY 2004, making them available through a web-based portal. Each operating division and functional unit designated portal administrators to provide access to other employees within its respective organization. The portal provides easy access to various OAR reports (e.g., open OARs, closed OARs) to manage the unit's OAR inventory, while protecting the confidentiality of the underlying taxpayer-provided information.

Service Level Agreements

The national Service Level Agreements (SLAs) between TAS and the four operating divisions have been in effect for over two years. These agreements set forth the manner and timeframe in which the IRS will receive, acknowledge, and resolve taxpayer cases that require OD actions. TAS recently signed SLAs with the Criminal Investigation and Appeals functions, with implementation scheduled for January 2005. The OAR reports described above enable TAS to monitor IRS compliance with the SLAs.

[9] Average is weighted for number of cases in each Operating and Functional Division.

Taxpayer Assistance Orders

Internal Revenue Code (IRC) § 7811 authorizes Local Taxpayer Advocates (LTAs) to issue a Taxpayer Assistance Order (TAO) when a taxpayer is suffering or about to suffer a significant hardship as a result of the IRS' administration of tax laws. TAS has two distinct categories of TAOs: the Direct TAO requires an IRS unit to take an action specifically authorized by IRC § 7811(b); and a Review TAO requires an IRS unit to expedite consideration of a taxpayer's case, review and reconsider its own determination, or review the determination at a higher level in that unit.

During FY 2004, TAS issued 30 Taxpayer Assistance Orders, up from 12 in FY 2003. The IRS completed the requested actions on 23 of the TAOs. Three were appealed by the IRS and modified by TAS prior to IRS completing the requested actions. Another TAO was initially appealed but was later agreed to after the subsequent conversations between the LTA and an IRS manager. TAS rescinded two TAOs due to the taxpayers' unwillingness to cooperate. The final TAO remains open at the time of this report. One of the TAOs was issued by the National Taxpayer Advocate to the Chief, Appeals.

IRC § 7811(b) further provides that the TAO may require the action(s) to be taken within a specified timeframe. All of the TAOs had specified timeframes, of which twelve were timely completed. Five of the TAOs were completed within 15 days of the specified time frame, three within 45 days and three within 100 days. The IRS took more than 100 days to take the actions requested in the remaining two TAOs, due to processing problems and delays. One is still pending. The timeframe requirement is not applicable for the TAOs that were rescinded. The following is a summary of the actions requested, categorized by compliance activities and processing issues.

TABLE 4.9, TAO ACTIONS REQUESTED ON COMPLIANCE AND PROCESSING ISSUES IN FY 2004

Compliance Issues	
Levy Issues	Release bank levy for 45 days in order for taxpayer to work with IRS in paying the liability
	Partial release of bank levy to alleviate taxpayer's financial hardship (3 cases)
	Full release of bank levy to alleviate taxpayer's financial hardship
	Return of levy proceeds due to the taxpayer not being provided the national standard exemption amounts
Seizure/Sale Issues	Postponement of auction to allow taxpayer time to full pay balance due
	Suspension of time to seize assets to allow taxpayer to establish a payment plan
Lien Issues	Lien withdrawal based on an Appeals determination
Offer in Compromise Issues	Consideration of an Offer in Compromise
	Reconsideration of a returned Offer in Compromise
	Reconsideration of a rejected Offer in Compromise
	Cessation of enforcement action while an Offer in Compromise is processed
	Appeals reconsideration of an Offer in Compromise
Examination Issues	Review of an Earned Income Tax Credit and Head of Household examination determination
	Review a disputed underreporter assessment
	Examination of an amended S Corporation return
	Appeals determination on an amended return
	Examination of an Innocent Spouse claim
	Reconsideration of an Innocent Spouse determination
	Reconsideration of a failure to file and pay penalty denial determination
	Expedite processing of an amended return
	Appeals review of denied claim on an amended tax return
Processing Issues	
Correcting Account Issues	Correct a non-master file account based on Appeals determination granting innocent spouse relief.
	Correct a Substitute for Return assessment
	Correct previously adjusted accounts involving net operating losses
	Correct previously adjusted accounts to reflect correct dates of credit transfers
Account Adjustment Issues	Process account adjustment of a Form 1040NR, U.S. Nonresident Alien Income Tax Return
	Process adjustment to clear the assessment statutory expiration date for tax assessments
	Process adjustment to reflect an Appeals Settlement Agreement

TAOs increased 150 percent in fiscal year 2004 over FY 2003. This can be attributed to:

- Training provided to TAS employees which reviewed the mechanics of the TAO process and provided case scenarios to identify situations where a TAO is appropriate.
- Emphasis during FY 2004 on the TAO as a tool to address delays by the IRS in resolving TAS cases open over 100 days, where IRS is the source of delay in resolving the issue.
- Emphasis on the TAO as a means of ensuring that taxpayer rights are protected in the course of a tax dispute.

Congressional Casework

TAS is responsible for the independent review of all tax account related inquiries sent to the IRS by members of Congress. TAS received 12,759 Congressional inquiries during FY 2004, 722 of which were duplicate Congressional inquiries.[10] Table 4.10 highlights the top ten issues identified in the Congressional inquiries.

TABLE 4.10, TOP TEN ISSUES IDENTIFIED IN CONGRESSIONAL INQUIRIES

Issue	Count
Levies (Including the Federal Payment Levy Program)	638
Other Refund Inquiries/Issues	556
Offer in Compromise - Doubt as to Collectibility	485
Request for Copies of Returns/Transcripts/Forms	409
Account/Notice Inquiry	408
Open Examination - non EITC	395
Audit Reconsiderations	390
Failure to File Penalty/Failure to Pay Penalties	372
Application for Exempt Status (Form 1023/1024)	366
EITC - Revenue Protection Strategy Examinations	307

Small Business Regulatory Enforcement Fairness Act (SBREFA) Casework

Under this 1996 act, small business owners facing regulatory problems with a Federal agency may contact the Small Business Administration and Agriculture Ombudsman (SBA Ombudsman) to register a complaint. The SBA Ombudsman in turn requests an explanation from the Federal agency involved, and TAS responds to all account related complaints made against the IRS. In FY 2004, TAS received 12 referrals from the SBA Ombudsman. Eighty-three percent of these referrals involve employment tax issues (e.g., deposit requirements, inability to pay, misapplied payments.)

[10] Duplicate congressionals are identified as cases with multiple congressional inquiries on the same taxpayer and the same issue. These cases are not reflected in TAS overall receipts and closure numbers.

SYSTEMIC ADVOCACY

The Taxpayer Advocate Service has a unique role in tax administration because of its ability to improve taxpayer compliance through advocacy. Many compliance issues and other tax problems are systemic in nature, affecting whole segments of the taxpayer population and demanding a different approach than individual cases. The TAS Office of Systemic Advocacy employs a clearly defined, focused strategy, through outreach efforts and advocacy issue submissions, for uncovering these problems and bringing them to resolution.

Systemic Advocacy identifies and analyzes issues through an enhanced web-based system, collecting input from our TAS and IRS colleagues, taxpayers, and tax professionals. Some systemic issues can be resolved through collaborative efforts with IRS organizations, while others require legislative solutions like those outlined elsewhere in this Report. Many of these problems are also identified during case advocacy encountered by the Local Taxpayer Advocates (LTAs). For this reason, the National Taxpayer Advocate's goal to integrate advocacy throughout TAS has been an area of emphasis.

Integrating Advocacy

Each Local Taxpayer Advocate is now also a *Portfolio Advisor*, and has developed an assigned advocacy portfolio topic for which he or she will serve as a TAS representative, provide a field perspective, and leverage field expertise by remaining current with existing information and new developments. These portfolios cover a wide range of issues that pertain to tax administration or TAS operations, including several Earned Income Tax Credit (EITC) issues, Offers In Compromise (OICs), identity theft, navigating the IRS, and the problems affecting international taxpayers. [11]

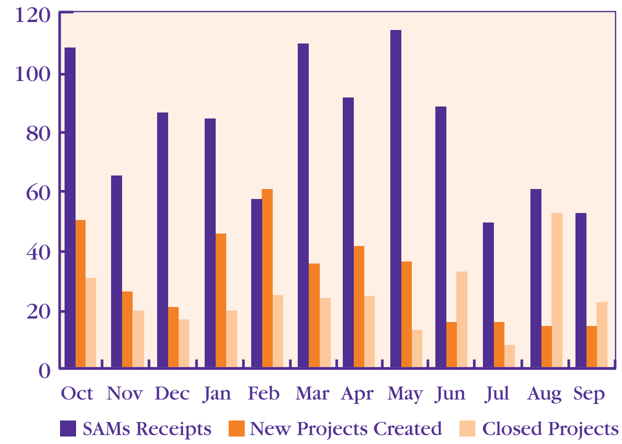
Systemic Advocacy Receipts

The TAS Office of Systemic Advocacy reviews and assigns advocacy work through the Systemic Advocacy Management System (SAMS).[12] Table 4.11 illustrates monthly receipts of issues from inside and outside the IRS, new advocacy projects created from receipts and project closures for fiscal year 2004.

[11] A full list of Advocacy Portfolios and the LTAs assigned to work them is available on the TAS pages of the IRS intranet at http://tasnew.web.irs.gov.

[12] SAMS is a database of advocacy issues submitted to TAS by IRS employees and the public, and the projects created from issues.

TABLE 4.11, FY 2004 SAMS RECEIPTS, NEW PROJECTS, AND CLOSURES



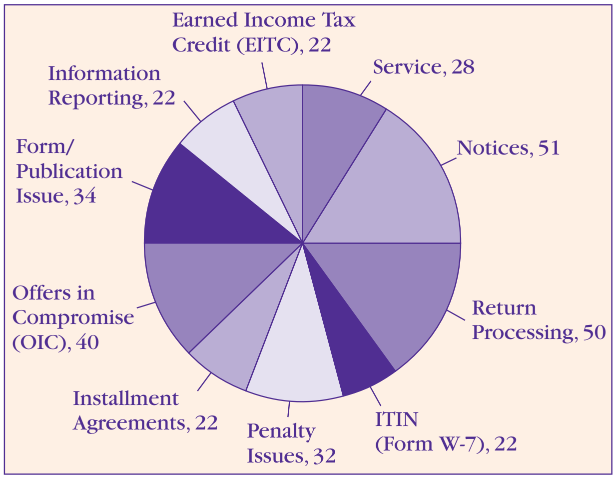
From Oct. 1, 2003 through Sept. 30, 2004, Systemic Advocacy received over 900 issues on SAMS, an increase of nearly 30 percent from the previous fiscal year. Approximately 23 percent of these issues were submitted by the public (e.g., taxpayers, academicians, and tax professionals) via the Internet.[13] Systemic Advocacy reviewed all submissions, using established criteria to prioritize inventory and develop advocacy projects. Approximately one-third of submissions were developed into new advocacy projects. The number of closed (completed) projects more than doubled over FY 2003.

As the above statistics make clear, most submissions do not become projects. Some (e.g., local issues) may not truly represent systemic problems, while others, such as requests for IRS system changes, can be better handled through existing processes. However, all submissions are continually assessed to identify trends and gain a comprehensive understanding of problems.

The top ten SAMS issues in fiscal year 2004 are depicted in Chart 4.12. The following issues from fiscal year 2003 were no longer present in the top ten: Refund Issues, Employment Taxes, Amended Returns, Navigating the IRS, and Access to the IRS.

[13] The Internet version of SAMS is available through the Systemic Advocacy pages of the TAS website at http://www.irs.gov/advocate.

CHART 4.12, TOP TEN ISSUE TOPICS IN SAMS IN FY 04 (WITH RECEIPT COUNT)



Systemic Advocacy Initiatives

The most significant problems encountered by taxpayers are contained in the Most Serious Problems portion of this Report. The following issues highlight other Systemic Advocacy activity recently completed or in process.

Earned Income Tax Credit Audit Reconsideration Study

In collaboration with the IRS' Offices of Reporting Compliance Examination for both the Wage & Investment and Small Business/Self-Employed divisions, TAS studied the audit reconsideration process as it applies to claims for the Earned Income Tax Credit (EITC). A taxpayer who disagrees with an IRS change to his or her tax liability and/or credits claimed can ask the IRS to reconsider, which nearly 67,000 EITC taxpayers did in fiscal year 2002.[14] Those who are eligible may seek assistance from TAS in the audit reconsideration process. The study reviewed a random sample of EITC audit reconsideration cases; the findings include the following:

- Of the cases included in the sample, approximately one half of the taxpayers requested a reconsideration of the EITC through IRS Examination (Exam) and the other half through TAS.
- Approximately 45 percent of the taxpayers who came to TAS for assistance received additional EITC from the audit reconsideration, compared to 40 percent who asked Exam for reconsideration.

[14] IRS Service Center Examination Branch, Business Measures Data Mart, Campus Exam Measures by Campus Report, Cycle End Date September 2002. Actual number of EITC audit reconsideration cases: 66,893.

- In more than 40 percent of the cases, difficulties with IRS documentation requirements were the reason for audit reconsideration. Communication challenges (taxpayers had not responded or responded late) were the trigger 38 percent of the time.
- TAS initiated an average of two contacts per case (telephone and letters - excluding the acknowledgement letter) to request EITC supporting documentation, while the Exam rate was about one contact for every two cases. Exam employees did not make a third or fourth contact request on any case in the sample.
- Seventy percent of the taxpayers stated they came to TAS because they had not heard from Exam about their original audits or reconsideration requests.
- The entire process -- from posting the return claiming EITC through the original audit, reconsideration, and final audit reconsideration outcome -- lasted an average of 1,000 days (2.7 years). During the audit reconsideration stage, the time span for a case with TAS assistance was 4.9 months; for a case processed solely by Examination it was 8.7 months.

TAS recommendations outlined in the study include improve communication with taxpayers during the initial audit; consider increasing telephone usage during all stages of the process to determine whether additional phone contacts with taxpayers can resolve the disputed EITC; and provide taxpayers with more assistance in understanding what specific documentation the IRS needs to resolve the audit.[15]

EITC NOTICE IMPROVEMENT TEAM

The EITC notice improvement initiative is part of the Commissioner's five-point strategy to improve service, fairness, and compliance in EITC processing. The IRS created the EITC Notice Redesign Team to make recommendations to improve EITC notices and processes. TAS, the Wage and Investment (W&I) and Small Business/Self-Employed (SB/SE) operating divisions and the Office of Appeals are represented on the team. The objective is to simplify the EITC examination process through revision, elimination, or improvement of notices and letters with the goals of educating the taxpayer, reducing processing time, making the examination process less burdensome to the taxpayer, and improving the effectiveness of the EITC audit trail.

The team analyzed EITC notices for report form, content, and clarity and expanded its review to include various types of enclosures (e.g., document requests, publications). The team incorporated into its recommendations information obtained through interviews with directors of Low Income Taxpayer Clinics (LITCs), the Taxpayer Advocacy Panel (TAP) EITC Issue Committee, and an independent taxpayer focus group on notice clarity.

[15] National Taxpayer Advocate, *Annual Report to Congress Volume II*, The National Taxpayer Advocate's Earned Income Tax Credit (EITC) Audit Reconsideration Study, (Pub. 2104) (Rev. 12-04).

One of the National Taxpayer Advocate's primary concerns is the issuance of the "30-day" notice (also known as the "combo" letter) at the time of first contact with the taxpayer. This notice gives the taxpayer 30 days to request an appeal within the IRS, but since the taxpayer has not yet responded to the IRS request for information, it is premature for him or her to request an appeal. After much deliberation, the EITC Program Office, W&I and SB/SE Compliance, and TAS agreed upon a proposal, which the Deputy Commissioner (Services and Enforcement) has approved, to issue two notices – the initial contact letter requesting documentation and providing the taxpayer with his or her legal rights followed by the 30-day notice if the taxpayer does not reply within the time specified in the initial contact.

Major changes in the notice program include informing taxpayers that they are under examination in the first notice, using the proper internal coding to show the examination has begun, providing the initial request for information in the first contact along with a clear and easy-to-read publication detailing taxpayer rights and including information about LITCs. The group also proposed to revise the document requests sent to taxpayers to secure information – making these requests easier to read and requesting only information that IRS cannot obtain elsewhere – and to provide the taxpayer with a "tear-off" coupon to request an appeal as a part of the 30-day notice.

Although the notices and other forms developed by the team were not used, the EITC program office does plan to issue two separate notices. The National Taxpayer Advocate continues to work directly with the EITC program office to ensure that taxpayers are given information about their appeals and court options, the Taxpayer Advocate Service, and Low Income Taxpayer Clinics. The EITC notice changes are scheduled to be implemented in FY 2005.

IDENTIFYING EITC TAXPAYER CUSTOMER SERVICE NEEDS

This research project will collect information from EITC taxpayers to enable the IRS to better understand their customer service needs. The proposed research entails development and administration of a survey to EITC taxpayers to identify their information needs (tax law questions, return preparation, etc.), and how effectively these needs are currently met through the Taxpayer Assistance Centers (TACs), IRS telephone assistance, the Internet, IRS publications, etc. The project will also include a separate section on customer attitudes concerning refund anticipation loans, cross-marketing, bank accounts, and direct deposit of refunds.

This research initiative will be conducted in two phases, with the first phase consisting of focus group sessions with EITC claimants to determine and describe the most relevant EITC customer service issues. The results will form the basis for the design of an appropriate survey instrument. The second phase will transmit the survey instrument to a representative sample of all EITC claimants to obtain quantifiable results on their views of the surveyed items. TAS will use the survey tabulations to recommend potential improvements in EITC customer service.

IDENTIFYING CORRESPONDENCE AUDIT BARRIERS EXPERIENCED BY EITC TAXPAYERS

This research endeavor is designed to identify the most significant barriers that taxpayers encounter during the EITC correspondence audit process by seeking feedback from taxpayers who have undergone EITC correspondence audits. In the first phase, trained IRS moderators will conduct telephone interviews with a small group of taxpayers who have previously participated in the EITC correspondence audit process. These interviews will be designed to obtain qualitative data for the identification and understanding of those significant barriers or problems encountered during the correspondence audit process. Subsequently, a survey will be developed from these interview results and administered to a representative sample of taxpayers experiencing recent EITC correspondence audits to quantify the impact these issues have on taxpayers. The IRS may utilize the results of the survey to improve the EITC correspondence audit process.

THE IMPACT OF REPRESENTATION ON THE OUTCOME OF EITC AUDITS

Although the tax year 1999 Earned Income Tax Credit compliance study indicates that a significant proportion of claimants have historically not been entitled to the EITC, the National Taxpayer Advocate believes that the study overstates the overclaim rate because it relied exclusively on the outcome of EITC audits. TAS data suggests that audit outcomes are frequently incorrect and a significant number of entitled taxpayers are erroneously denied the credit. Evidence also suggests that represented taxpayers fare considerably better than unrepresented ones in the process of resolving tax controversy disputes. TAS therefore partnered with the IRS Office of Research in FY 2004 to design a study to evaluate the impact of representation on the ultimate outcome of EITC audits. TAS will track the outcomes of EITC audits conducted during the National Research Program (NRP) initiative.

The NRP studies a representative national sample of tax returns to evaluate current compliance rates and provide data for audit workload selection in the future. Some of these taxpayers undergo face-to-face or correspondence audits. At the request of TAS, these taxpayers received a notice with the “first contact” letter that informs them about the availability of free representation through the Low Income Taxpayer Clinic program. The NRP also records data on the presence or absence of representation during the audit.

The planned study intends to select a portion of the over 6,000 returns of the NRP sample that claimed EITC. Specifically, the TAS sample will utilize those NRP returns which had EITC issues identified for audit by the IRS classifiers. The study will segment the NRP returns audited for EITC issues into two groups based on whether representation was present. The NRP results of these two groups will be compared to determine whether a difference exists in the audit outcome (both allowance of EITC and the amount of allowance) of the EITC issue.

Additionally, TAS personnel will use IRS computer systems to track the NRP EITC audit population throughout the audit process. This will include monitoring cases that go to Appeals, Tax Court, the Court of Claims, and District Court to obtain the ultimate disposition of each case. The outcome at each stage of this process will be noted, and results for represented taxpayers will be compared to results for taxpayers that did not have representation. Moreover, results from administrative and judicially appealed cases will be compared to the original audit results to provide inference regarding the accuracy of the original audit.

NRP data providing audit outcomes will be available during FY 2005. Initial study results to determine the effect of representation during the initial audit should also be available during FY 2005. Final results for those taxpayers who pursue additional avenues of adjudication may not be available, however, for an extended period of time, as subsequent activity of these taxpayers will be tracked to capture outcomes from the IRS Appeals function, the United States Tax Court, the Court of Claims, and District Court.

Other Initiatives

IRC § 179 REGULATIONS

The Office of Systemic Advocacy gave critical support to a change in regulations regarding the IRC § 179 election (Election to Expense Certain Property) by developing a legislative proposal allowing taxpayers to make or revoke an IRC § 179 election on an amended return. At the time, elections were only allowed on or before the original due date of the return, plus extensions.

IRS Counsel took action by issuing its own proposal to modify the regulations. TAS suggested clarifying language that taxpayers could now make or revoke this election not only during the original time period for filing (plus extensions) but on an amended return. This recommendation was incorporated into the temporary published regulations.[16]

[16] Treas. Reg. § 1.179(5T). For any taxable year beginning after 2002 and before 2006, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for such taxable year.

SOCIAL SECURITY – LEVY RELEASES

The Social Security Administration (SSA) can take up to three months to process IRS levy releases while it continues to send payments to the IRS. This causes IRS to issue multiple manual refunds to return these payments in cases when the taxpayer is experiencing a financial hardship. TAS and the SSA have agreed to an interim solution for SSA to expedite levy releases for taxpayers facing hardships. In the long term, SSA is working to automate the levy process, which should eliminate the delays in releasing levies.

DISCLOSURE AND THE SSA

The government's Financial Management Service (FMS), which issues checks for tax levies on federal payments for SSA, places a six-line address on the checks, including the SSN of the person being levied. This information also appeared in the window of the envelope, creating a disclosure problem. TAS, the IRS, and SSA worked with FMS to remedy this situation by proposing a SSA programming change to resolve 95 percent of these cases. The remaining five percent would cause substantial account processing problems for the IRS. The parties have agreed on an interim manual processing solution for fiscal year 2005. An automated process that would eliminate the delays is expected to be in place for the 2006 fiscal year.

FEDERAL TAX DEPOSIT PENALTY TASK FORCE

In the 2003 Annual Report to Congress, the National Taxpayer Advocate recommended the IRS assemble a team or group to perform a comprehensive analysis of the Federal Tax Deposit (FTD) system.[17] The Headquarters Program Manager of the Office of Penalties and Interest Administration convened a cross-functional group to analyze systemic assessments and abatements of FTD penalties, identify the causes, recommend measurable solutions, and support the Office of Penalties and Interest's initiatives to reduce taxpayer burden.[18] TAS continues to monitor the progress of this team and the timeliness of its activities.

SIMPLIFICATION OF THE EXTENSION TO FILE PROCESS

TAS is a part of the cross-functional "Extension" task force, whose goal is to simplify and lessen the burden of requesting an extension of time to file a tax return, and to increase efficiency in processing requests for extensions. This includes creating as much consistency in extension periods as possible; designing as few application forms as possible; and centralizing their processing. TAS is discussing proposed changes to the extension regulations with the Office of Taxpayer Burden Reduction and IRS Counsel. TAS is also providing comments for the proposed new simplified extension forms, one for individual taxpayers and one for business taxpayers.

[17] National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2003) p. 205.

[18] The Office of Penalties and Interest, housed in SBSE under Compliance Policy, develops and implements Servicewide policies and strategies for penalties and interest. The Headquarters Program Manager of Penalties and Interest has the objective of administering penalties and interest for all Business Operating Divisions in a manner that is consistent and accurate for all taxpayers

PENALTY ADMINISTRATION TEAM

The Large and Mid-Sized Business Operating Division (LMSB) sponsored another cross-functional team to review penalty development, application, and resolution, specifically the "Accuracy-Related Penalty" (IRC § 6662) in the context of tax shelters. A subsequent phase of this effort will look at penalties from a broader perspective. One of the goals of the team was to develop a communication strategy that would give examiners confidence that Appeals would sustain penalties applied by the field. The National Taxpayer Advocate believes that taxpayers must have the opportunity for an independent review of their cases with Appeals, which should take a fresh look at each case and consider the facts and circumstances when asserting and sustaining penalties. TAS will continue to monitor the recommendations of this team to ensure that taxpayers retain the ability to have an independent appellate review.

APPENDIX

TOP 25 CASE ADVOCACY ISSUES FOR FY 2004 IDENTIFIED ON TAMIS[1]

MI Code	Description	Total
950	Criminal Investigation	16,460
330	Processing Amended Returns	11,180
630	Earned Income Tax Credit (EITC)- Revenue Protection Strategy Examinations	10,179
710	Levies (Including the Federal Payment Levy Program)	8,857
310	Processing Original Returns	8,493
020	Expedite Refund Requests	7,158
620	Audit Reconsiderations	7,131
340	Injured Spouse Claims	6,129
610	Open Examinations- Non EITC	4,773
670	Underreporter Process Reconsiderations	4,563
150	Copies of Returns/Transcripts/Reports/Forms	4,081
090	Other Refund Inquiries/Issues	3,640
210	Missing/Incorrect Payments	3,523
520	Failure to File Penalty / Failure to Pay	3,070
010	Lost/Stolen Refunds	2,962
640	EITC Recertification)	2,719
450	Form W-7/ITIN/ATIN	2,658
675	CAWR/FUTA	2,653
660	Open Underreporter Process	2,485
721	Lien Release	2,481
780	OIC - Doubt as to Collectibility	2,383
390	Other Document Processing Issues	2,198
060	IRS Offset	2,085
110	Account/Notice Inquiry	2,077
040	Returned/Stopped Refunds	1,907
	Total	**125,845**
	Grand Total – ALL TAS Cases FY04	**168,856**

[1] Taxpayer Advocate Management Information System.

THE MOST LITIGATED TAX ISSUES: TABLES OF LITIGATED CASES

TABLE 1,
COLLECTION DUE PROCESS (CDP), IRC §§ 6320 AND 6330

Case Cite	Issue (s)[1]	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Aaron v. Comm'r, T.C. Memo. 2004-65	Lien and Levy	Yes	IRS
Alvarez v. Comm'r, T.C. Memo. 2003-319	Lien	Yes	IRS
Ashurst v. Comm'r, T.C. Summ. Op. 2004-14	Levy	Yes	IRS
Barnett v. U.S., 92 A.F.T.R.2d (RIA) 5689 (M.D. Fla. 2003)	Levy	Yes	IRS
Beery v. Comm'r, 122 T.C. 184 (2004)	Lien and Levy	Yes	IRS
Belmont v. U.S., 93 A.F.T.R.2d (RIA) 1992 (N.D. Ohio 2004)	Lien	Yes	IRS
Bethea v. Comm'r, T.C. Memo. 2003-278	Levy	Yes	IRS
Blank v. Comm'r, T.C. Summ. Op. 2003-95	Lien	Yes	IRS
Boyd v. U.S., 322 F.Supp.2d 1229 (D. N.M. 2004)	Levy	Yes	IRS
Boyer v. Comm'r, T.C. Memo. 2003-322	Levy	Yes	IRS
Brashear v. Comm'r, T.C. Memo. 2003-196	Lien	Yes	IRS
Broderick v. U.S., 93 A.F.T.R.2d (RIA) 350 (9th Cir. 2003)	Levy	Yes	IRS
Brodman v. Comm'r, T.C. Memo. 2003-230	Lien and Levy	No	IRS
Brown v. Comm'r, T.C. Summ. Op. 2004-45	Levy	Yes	Split
Brown v. Comm'r, T.C. Memo. 2003-261	Levy	No	IRS
Brown v. Doran, 92 A.F.T.R.2d (RIA) 7409 (M.D.N.C. 2003)	Levy	Yes	IRS
Bunch v. U.S., 93 A.F.T.R.2d (RIA) 2332 (D. Nev. 2004)	Levy	Yes	IRS
Burbridge v. Comm'r, T.C. Memo. 2004-88	Levy	Yes	IRS
Cabirac v. Comm'r, 92 A.F.T.R.2d (RIA) 5269 (E.D. Pa. 2003)	UTD	Yes	IRS
Carmichael v. U.S., 93 A.F.T.R.2d (RIA) 1026 (D.N.J. 2004)	Levy	Yes	IRS
Carrillo v. U.S., 92 A.F.T.R.2d (RIA) 5917 (9th Cir. 2003)	UTD	Yes	IRS
Chandler v. Comm'r, T.C. Memo. 2004-7	Levy	Yes	IRS
Cheslin v. U.S., 93 A.F.T.R.2d (RIA) 765 (9th Cir. 2004)	UTD	Yes	IRS
Cipolla (1) v. Comm'r, T.C. Memo. 2004-6	Levy	Yes	IRS
Cipolla (2) v. U.S., 92 A.F.T.R.2d (RIA) 6975 (E.D.N.Y.2003)	Levy	Yes	IRS
Clouse v. Comm'r, 93 A.F.T.R.2d (RIA) 427 (N.D. Ohio 2003)	Levy	No	IRS
Collins v. Comm'r, T.C. Memo. 2003-293	Levy	Yes	IRS
Conlon v. Comm'r, T.C. Summ. Op. 2003-135	Levy	Yes	IRS
Cook v. Comm'r, T.C. Summ. Op. 2004-67	Levy	Yes	IRS
Crisan v. Comm'r, T.C. Memo. 2003-318	Levy	Yes	IRS
Daugherty v. Comm'r, 93 A.F.T.R.2d (RIA) 648 (10th Cir.2004)	Levy	Yes	IRS
Day v. Comm'r, T.C. Memo. 2004-30	Levy	Yes	IRS
Deputy v. Comm'r, T.C. Memo. 2003-210	Levy	Yes	IRS
Dixon v. Comm'r, T.C. Summ. Op. 2003-14	Lien	No	IRS
Dorn v. Comm'r, T.C. Memo. 2003-192	Levy	Yes	IRS
Dorra v. Comm'r, T.C. Memo. 2004-16	Lien	Yes	IRS
Dunham v. Comm'r, T.C. Memo. 2003-260	Levy	No	IRS
Durrenberger v. Comm'r, T.C. Memo. 2004-44	Lien	Yes	IRS
Dwain v. Comm'r, T.C. Summ. Op. 2004-44	Levy	No	Taxpayer
Everman v. Comm'r, 93 A.F.T.R.2d (RIA) 857 (N.D. Ohio 2004)	Levy	No	IRS
Fargo v. Comm'r, T.C. Memo. 2004-13	Levy	No	IRS
Fingado v. U.S., 92 A.F.T.R.2d (RIA) 6283 (D. N. M. 2003)	Levy	Yes	IRS
Flood v. Comm'r, T.C. Summ. Op. 2003-120	Lien	Yes	IRS
Ford v. U.S., 92 A.F.T.R.2d (RIA) 5179 (M.D. Ala. 2003)	Levy	Yes	IRS
Frank v. U.S., 92 A.F.T.R.2d (RIA) 5556 (N.D. Ind. 2003)	UTD	Yes	IRS
Frey v. Comm'r, T.C. Memo. 2004-87	Levy	Yes	IRS
Fusaro v. Comm'r, T.C. Memo. 2003-345	Levy	No	IRS
Gadsden v. Comm'r, 92 A.F.T.R.2d (RIA) 7139 250 (9th Cir. 2003)	Levy	Yes	IRS
Galvin v. Comm'r, T.C. Memo. 2003-263	Levy	Yes	IRS
Ginalski v. Comm'r, T.C. Memo. 2004-104	Lien	No	IRS

TABLE 1

COLLECTION DUE PROCESS (CDP), IRC §§ 6320 AND 6330 (CONT.)

Case Cite	Issue (s)[1]	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Glass v. Comm'r, T.C. Summ. Op. 2004-73	Levy	Yes	IRS
Gnifkowski v. U.S., 93 A.F.T.R.2d (RIA) 1159 (D. Minn. 2004)	Lien and Levy	No	IRS
Godwin v. Comm'r, T.C. Memo. 2003-289	Levy	Yes	IRS
Goldman v. Comm'r, T.C. Memo. 2004-3	Lien	Yes	IRS
Green v. Comm'r, T.C. Memo. 2003-264	Lien	No	IRS
Greulich v. Comm'r, T.C. Summ. Op. 2003-171	Lien	No	IRS
Haines v. Comm'r, 92 A.F.T.R.2d (RIA) 5939 (9th Cir. 2003)	Levy	Yes	IRS
Hardy v. U.S., 91 A.F.T.R.2d (RIA) 2668 (N.D. Ala. 2003)	Levy	Yes	IRS
Harkey v. Comm'r, T.C. Summ. Op. 2003-87	Levy	Yes	IRS
Harrell v. Comm'r, T.C. Memo. 2003-271	Levy	No	Split
Hart v. U.S., 291 F. Supp.2d 635 (N.D. Ohio 2003)	Levy	Yes	IRS
Hawks v. Comm'r, 92 A.F.T.R.2d (RIA) 5663 (9th Cir.2003)	Lien	Yes	IRS
Helvie v. U.S., 92 A.F.T.R.2d (RIA) 5757 (S.D. Fla. 2003)	Levy	Yes	IRS
Henderson v. Comm'r, T.C. Memo. 2004-36	Levy	Yes	IRS
Herrick v. Comm'r, T.C. Memo. 2003-167	Levy	Yes	IRS
Hill v. Comm'r, 93 A.F.T.R.2d (RIA) 1620 (9th Cir. 2004)	Lien and Levy	Yes	IRS
Hiltz v. Comm'r, T.C. Memo. 2004-38	Lien	Yes	IRS
Hoffman v. U.S., 93 A.F.T.R.2d (RIA) 391 (W.D. Wash. 2003)	Levy	Yes	IRS
Horton v. Comm'r, T.C. Memo. 2003-197	Lien	Yes	IRS
Humphries v. Comm'r, T.C. Summ. Op. 2003-111	Levy	Yes	IRS
Iannone v. Comm'r, 122 T.C. 287 (2004)	Levy	No	IRS
Israel v. Comm'r, T.C. Memo. 2003-198, *aff'd*, 93 A.F.T.R.2d (RIA) 1824 (7th Cir. 2004)	Levy	Yes	Split
Jewett v. Comm'r, 292 F.Supp.2d 962 (N.D. Ohio 2003)	Lien	Yes	IRS
Johnson v. Comm'r, T.C. Memo. 2004-73	Lien	Yes	IRS
Jones v. Comm'r, 338 F.3d 463 (5th Cir. 2003)	Levy	Yes	IRS
Kemper (1) v. U.S., 92 A.F.T.R.2d (RIA) 5248 (D. Nev. 2003)	Lien and Levy	Yes	IRS
Kemper (2) v. Comm'r, T.C. Memo. 2003-195	Levy	Yes	IRS
Leineweber v. Comm'r, T.C. Memo. 2004-17	Levy	Yes	IRS
Lewis v. Comm'r, 93 A.F.T.R.2d (RIA) 2290 (S.D.N.Y. 2004)	Levy	Yes	IRS
Lister v. U.S., 92 A.F.T.R.2d (RIA) 6408 (10th Cir. 2003)	Lien	Yes	IRS
Luna v. Comm'r, T.C. Summ. Op. 2004-35	Lien	Yes	IRS
Marino v. U.S., 357 F.3d 143 (1st Cir. 2004)	Lien	Yes	IRS
Martin v. Comm'r, T.C. Memo. 2003-288, *Supplemented on Denial of Reconsideration by*, T.C. Memo. 2004-14	Levy	No	IRS
Mayben v. U.S., 92 A.F.T.R.2d (RIA) 5071 (D. Nev. 2003)	UTD	Yes	IRS
McDonald v. U.S., 92 A.F.T.R.2d (RIA) 7197 (N.D. Tex. 2003)	Levy	Yes	IRS
McIntosh v. Comm'r, T.C. Memo. 2003-279	Levy	Yes	IRS
Milam v. Comm'r, T.C. Memo. 2004-94	Lien	Yes	IRS
Minion v. Comm'r, 92 A.F.T.R.2d (RIA) 6634 (6th Cir. 2003)	Levy	Yes	IRS
Montgomery v. Comm'r, 122 T.C. 1 (2004)	Levy	No	Taxpayer
Moorhous v. Comm'r, T.C. Memo. 2003-183	Levy	No	IRS
Muhammad v. U.S., 92 A.F.T.R.2d (RIA) 6750 (D.S.C. 2003), *Report and Recommendation Adopted by* 93 A.F.T.R.2d (RIA) 2037 (D.S.C. 2004)	Levy	Yes	IRS
Neugebauer (1) v. Comm'r, T.C. Memo. 2003-276	Levy	Yes	IRS
Neugebauer (2) v. Comm'r, T.C. Memo. 2003-292	Levy	Yes	IRS
Nicol v. Comm'r, T.C. Summ. Op. 2004-47	Levy	Yes	IRS
Nitschke v. U.S., 93 A.F.T.R.2d (RIA) 1848 (9th Cir. 2004)	Lien and Levy	Yes	IRS

TABLE 1
COLLECTION DUE PROCESS (CDP), IRC §§ 6320 AND 6330 (CONT.)

Case Cite	Issue (s)[1]	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Norsworthy v. Killfoil, 93 A.F.T.R.2d (RIA) 1700 (W.D. Tex. 2004)	Levy	Yes	IRS
Ordunez v. U.S., 92 A.F.T.R.2d 6297 (9th Cir. 2003)	Lien	Yes	IRS
Parikh v. Comm'r, T.C. Memo. 2003-341	Levy	Yes	IRS
Peacock v. Comm'r, T.C. Memo. 2003-206	Levy	No	IRS
Perkins v. U.S., 314 F.Supp.2d 664 (E.D. Tex.2004), *recommendation adopted*, 93 A.F.T.R2d 2766 (E.D. Tex. 2004)	Levy	Yes	IRS
Pierce v. Comm'r, T.C. Summ. Op. 2003-126	Levy	Yes	IRS
Rabinovich v. Comm'r, T.C. Summ. Op. 2004-15	Levy	Yes	IRS
Ramirez v. Comm'r, T.C. Summ. Op. 2004-48	Levy	Yes	Taxpayer
Ramsdell v. Comm'r, T.C. Memo. 2003-317	Levy	Yes	IRS
Randle v. U.S., 92 A.F.T.R.2d (RIA) 5542 (E.D. Pa. 2003)	Lien	Yes	IRS
Ray v. U.S., 291 F. Supp.2d 1179 (D. Nev. 2003)	Levy	Yes	IRS
Razo v. Comm'r, T.C. Memo. 2004-101	Lien	No	IRS
Rehberg v. Comm'r, T.C. Summ. Op. 2004-41	Levy	Yes	IRS
Ringgold v. Comm'r, T.C. Memo. 2003-199	Lien	Yes	IRS
Roberts v. Comm'r, T.C. Memo. 2004-100	Levy	No	IRS
Robertson v. Comm'r, T.C. Memo. 2004-72	Levy	Yes	Split
Rudd v. Comm'r, 93 A.F.T.R.2d (RIA) 1021 (1st Cir. 2004)	Levy	Yes	IRS
Sapp v. Comm'r, T.C. Memo. 2003-207	Levy	Yes	IRS
Sciola v. Comm'r, T.C. Memo. 2003-334	Lien	Yes	IRS
Sheppard v. U.S., 92 A.F.T.R.2d (RIA) 7352 (D. Nev. 2003)	Lien and Levy	Yes	IRS
Silver v. Smith, 92 A.F.T.R.2d (RIA) 5016 (2nd Cir. 2003)	Lien	Yes	IRS
Smith v. Comm'r, T.C. Memo. 2003-205	Levy	Yes	IRS
Smith v. Comm'r, T.C. Summ. Op. 2004-70	Lien	Yes	IRS
Snyder v. Comm'r, 93 A.F.T.R.2d (RIA) 425 (N.D. Ohio 2003)	Lien and Levy	No	IRS
Standifird v. Comm'r, 92 A.F.T.R.2d 2003-5936 729 (9th Cir. 2003)	Levy	Yes	IRS
Swanson v. Comm'r, 121 T.C. 111 (2003)	Levy	Yes	IRS
Taylor v. Comm'r, T.C. Memo. 2004-25	Lien and Levy	Yes	IRS
Thomas v. Comm'r, T.C. Memo. 2003-231	Lien	Yes	IRS
Tilley v. U.S., 93 A.F.T.R.2d (RIA) 439 (4th Cir. 2004), *aff'g*, 270 F. Supp.2d 731 (M.D. N.C. 2003)	Lien and Levy	Yes	IRS
Tillman v. Comm'r, T.C. Memo. 2004-8	Levy	Yes	IRS
Tolotti v. Comm'r, 92 A.F.T.R.2d (RIA) 5668 (9th Cir. 2003)	Lien and Levy	Yes	IRS
Townes v. Comm'r, 92 A.F.T.R.2d 5862 (9th Cir. 2003)	Lien and Levy	Yes	IRS
Van Gaasbeck v. U.S., 93 A.F.T.R.2d (RIA) 1061 (D. Nev. 2004)	Levy	Yes	IRS
Voelker v. U.S., 365 F.3d 580 (7th Cir. 2004)	Levy	Yes	IRS
Voorhees v. Comm'r, T.C. Memo. 2004-105	Levy	Yes	IRS
Wall v. Comm'r, T.C. Summ. Op. 2003-165	Levy	Yes	IRS
Warren v. Comm'r, T.C. Summ. Op. 2003-76	Lien and Levy	Yes	IRS
Weber v. Comm'r, 122 T.C. 258 (2004)	Lien and Levy	Yes	IRS
Wells v. Comm'r, T.C. Memo. 2003-234	Levy	Yes	IRS
White v. U.S., 92 A.F.T.R.2d 5172 (M.D. Tenn. 2003), *Adhered to on Reconsideration by* 93 A.F.T.R.2d 1034 (M.D. Tenn. 2004)	Levy	Yes	IRS
Wilborn v. Comm'r, T.C. Summ. Op. 2003-152	Lien and Levy	Yes	IRS
Wingert v. Comm'r, T.C. Memo. 2003-172	Levy	Yes	IRS
Yuen v. U.S., 209 F. Supp. 2d 1220 (D. Nev. 2003)	Lien	Yes	IRS

TABLE 1
COLLECTION DUE PROCESS (CDP), IRC §§ 6320 AND 6330 (CONT.)

Case Cite	Issue (s)[1]	Pro Se	Decision
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)			
Abu-Awad v. U.S., 294 F.Supp.2d 879 (S.D. Tex. 2003)	Lien	No	IRS
Action Employment Resources, Inc. v. U.S., 94 A.F.T.R.2d (RIA) 5747 (D. Ariz. 2004)	Lien and Levy	No	IRS
Bartolomeo v. U.S., 292 F.Supp.2d 728 (W.D. Pa. 2003)	Lien	No	IRS
Cavanaugh v. U.S., 93 A.F.T.R.2d (RIA) 1522 (D. N.J. 2004)	Levy	No	Taxpayer
Christian v. Comm'r, 91 A.F.T.R.2d (RIA) 2677 (E.D. Pa. 2003)	UTD	Yes	IRS
Clawson v. Comm'r, T.C. Memo. 2004-106	Levy	No	IRS
Criner v. Comm'r, T.C. Memo. 2003-328	Lien	Yes	IRS
Desire Community Housing Corporation v. U.S., 93 A.F.T.R.2d (RIA) 1460 (E.D. La. 2004)	Lien	No	IRS
F.E. Schumacher Company, Inc. v. U.S., 308 F.Supp.2d 819 (N.D. Ohio 2004)	Levy	No	IRS
Hathaway v. Comm'r, T.C. Memo. 2004-15	Lien	Yes	IRS
Heaphy v. Comm'r, T.C. Memo. 2004-48	Lien	Yes	IRS
Hyler v. U.S., 93 A.F.T.R.2d (RIA) 1976 (N.D. Cal. 2003).	Levy	UTD	IRS
Jensen v. Comm'r, T.C. Memo. 2004-120	Lien	Yes	IRS
Johnson v. U.S., 92 A.F.T.R.2d (RIA) 7233 (N.D. Ga. 2003)	Levy	No	IRS
Keene v. Comm'r, 121 T.C. 8 (2003)	Levy	Yes	Taxpayer
Lah v. Comm'r, T.C. Summ. Op. 2003-112	Levy	Yes	IRS
Langer v. U.S., 92 A.F.T.R.2d (RIA) 7267 (D. Minn. 2003)	Lien and Levy	Yes	IRS
Leiter v. U.S., 93 A.F.T.R.2d (RIA) 793 (D. Kan. 2004)	Levy	No	IRS
Living Care Alternatives of Utica, Inc. (1) v. U.S., 93 A.F.T.R.2d 2004-761 (S.D. Ohio 2003)	Lien and Levy	No	IRS
Living Care Alternatives of Utica, Inc. (2) v. U.S., 312 F. Supp. 2d 929 (S.D. Ohio 2004)	Lien and Levy	No	IRS
Magnolia Media Group Ltd. v. U.S., 93 A.F.T.R.2d (RIA) 340 (N.D. Tex. 2003)	Levy	No	IRS
McLee v. Comm'r, T.C. Memo. 2003-252	Levy	Yes	IRS
Medical Psychiatric Association v. U.S., 91 A.F.T.R.2d (RIA) 2733 (N.D. Tex. 2003)	Lien	No	IRS
Miller v. U.S., 93 A.F.T.R.2d (RIA) 1148 (E.D. Pa. 2004)	Lien	Yes	IRS
O'Brien v. Comm'r, T.C. Memo. 2003-290	Lien	No	IRS
Owens Motor Coach, Inc. v. U.S., 92 A.F.T.R.2d (RIA) 6981 (W.D. Pa. 2003)	Lien and Levy	No	IRS
Oyer v. Comm'r, T.C. Memo. 2003-178, aff'd, 93 A.F.T.R.2d (RIA) 2360 (8th Cir. 2004)	Lien	No	IRS
Pahamotang v. Comm'r, T.C. Memo. 2003-177	Levy	Yes	IRS
PCT Services, Inc. v. U.S., 92 A.F.T.R.2d (RIA) 5234 (N.D. Ga. 2003)	Lien	No	IRS
Pepper Pot Trust v. Comm'r, T.C. Memo. 2003-287	Lien and Levy	Yes	IRS
Pless v. Comm'r, T.C. Memo. 2004-24	Levy	Yes	IRS
Plettner v. U.S., 92 A.F.T.R.2d (RIA) 5762 (N. D. Ill. 2003)	Lien	Yes	IRS
Poindexter v. Comm'r, 122 T.C. 280 (2004)	Levy	No	IRS
Priestly v. Comm'r, T.C. Memo. 2003-267	Levy	Yes	IRS
Ratke v. Comm'r, T.C. Memo. 2004-86	Levy	No	Taxpayer
Roman v. Comm'r, T.C. Memo. 2004-20	Levy	No	IRS
Schwemmer v. Comm'r, T.C. Summ. Op. 2003-138	Lien and Levy	Yes	IRS
STA Painting Co. v. U.S., 93 A.F.T.R.2d (RIA) 919 (E.D. Pa. 2004)	Lien and Levy	No	IRS
Stein v. Comm'r, T.C. Memo. 2004-124	Lien	Yes	IRS
Stewart v. Comm'r, 93 A.F.T.R.2d (RIA) 1463 (W.D. Pa. 2004)	Lien and Levy	Yes	IRS
Van Vlaenderen v. Comm'r, T.C. Memo. 2003-346	Levy	Yes	IRS
White v. U.S., 92 A.F.T.R.2d (RIA) 5177 (W.D. Wash. 2003)	Levy	Yes	IRS
Willis v. Comm'r, T.C. Memo. 2003-302	Levy	No	IRS
Wolk v. Comm'r, T.C. Summ. Op. 2003-173	Lien	Yes	IRS

TABLE 2
INCOME, IRC § 61(A)

Case Cite	Issue (s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Amos, Jr. v. Comm'r, T.C. Memo. 2003-329	Settlement Income partially allocated to personal injury/ IRC § 104(a)(2)	No	Split
Anderson v. Comm'r, T.C. Summ. Op. 2003-169	Debt Cancellation is Income	Yes	IRS
Armstrong v. Comm'r, T.C. Summ. Op. 2003-90	Debt Cancellation is income	Yes	IRS
Banaitis v. Comm'r, 340 F.3d 1074, 340 F.3d 1074 (9th Cir. 2003), *cert. granted*, 124 S.Ct. 1713 (2004)	Settlement Income Not Excluded- IRC § 104(a)(2)/ Contingent Attorneys' Fees	No	Split
Banks v. Comm'r, 345 F.3d 373, (6th Cir. 2003), *cert. granted*, 124 S.Ct. 1712(2004)	Settlement Income Not Excluded/ Contingent Attorneys' Fees Excluded	No	Split
Berardi v. U.S., 92 A.F.T.R.2d (RIA) 5669 (3rd Cir. 2003)	Gambling Income	No	IRS
Bland v. Comm'r, T.C. Summ. Op. 2003-172	Unreported Income	Yes	Taxpayer
Bunce v. Comm'r, T.C. Summ. Op. 2003-141	Retirement Income	Yes	IRS
Burke v. Comm'r, T.C. Summ. Op. 2003-77	Retirement Income	Yes	IRS
Carskadon v. Comm'r, T.C. Memo. 2003-237	Frivolous Argument	Yes	IRS
Ciciora v. Comm'r, T.C. Memo. 2003-202	Frivolous Argument	Yes	IRS
Cotterell v. Comm'r, T.C. Summ. Op. 2003-145	Settlement Income IRC § 104(a)(2)	Yes	IRS
Curtis v. Comm'r, 92 A.F.T.R.2d (RIA) 5664 (3rd Cir. 2003)	Taxability of Rental Income is Frivolous but Remand Due to Erroneous Notice	Yes	Split
Dato-Nodurft v. Comm'r, T.C. Memo. 2004-119	Alimony is Income	Yes	IRS
Davis v. Comm'r, T.C. Summ. Op. 2004-40	Disability / Social Security Payments	Yes	IRS
Demetree v. Comm'r, T.C. Memo. 2003-323	Items Identified are Nontaxable Gifts/Loans and Other Items Taxable	No	Split
Diers v. Comm'r, T.C. Memo. 2003-229	Commission Advance is Income	Yes	IRS
Dorroh v. Comm'r, T.C. Summ. Op. 2003-93	Settlement Income IRC § 104(a)(2)	Yes	IRS
Dubois v. Comm'r, T.C. Memo. 2003-222	Gambling Winnings are Income	Yes	IRS
Enloe v. Comm'r, T.C. Summ. Op. 2003-81	Pension Income IRC § 105	No	IRS
Evans v. U.S., 92 A.F.T.R.2d (RIA) 6703 (E.D. Pa. 2003)	Frivolous Argument/Wages are Income	Yes	IRS
Frey v. Comm'r, T.C. Memo. 2004-87	Frivolous Argument	Yes	IRS
Gaines v. Comm'r, T.C. Summ. Op. 2003-127	Underreported Income	No	IRS
Gerard v. Comm'r, T.C. Memo. 2003-320	Settlement Income Partially Attributable to Physical Injury IRC § 104(a)(2)	No	Split
Gilmore v. Comm'r, T.C. Summ. Op. 2004-60	Retirement Income	Yes	IRS
Haessly v. Comm'r, 92 A.F.T.R.2d 5167 (9th Cir. 2003)	Foreign Source Income/ IRC § 931	No	IRS
Hawkins v. Comm'r, T.C. Memo. 2003-181	Tax Does Not Violate Religious Freedom Restoration Act	Yes	IRS
Hautzinger v. Comm'r, T.C. Memo. 2003-236	Foreign Source Income / IRC § 931	Yes	IRS
Hayden v. Comm'r, T.C. Memo. 2003-184	Disability Income IRC § 105	No	IRS
Henderson v. Comm'r, T.C. Memo. 2003-168	Settlement Income IRC § 104(a)(2)	Yes	IRS
Howard v. Comm'r, T.C. Summ. Op. 2003-124	Unreported Income	Yes	IRS
Huang v. Comm'r, T.C. Summ. Op. 2003-99	Interest on Retirement Account Properly Rolled Over	Yes	Taxpayer
Imberger v. Comm'r, T.C. Summ. Op. 2003-156	Gambling Income	Yes	IRS
In re Booker, 301 B.R. 207 (N.D. OH 2003)	Foster Placement Income Not Excluded	No	IRS
Jeanmarie v. Comm'r, T.C. Memo. 2003-337	Disability Income IRC § 104(a)(4)	Yes	IRS
Johnson v. Comm'r, 92 A.F.T.R.2d (RIA) 5969 (10th Cir. 2003)	Settlement Income IRC § 104(a)(2)	No	IRS
Johnson v. U.S., 291 F.Supp.2d 1163 (E.D. Cal. 2003)	Frivolous Argument/Wages Are Income	Yes	IRS
Kerns v. Comm'r, T.C. Memo. 2004-63	Dividend Income	No	IRS
Kerr v. Comm'r, T.C. Memo. 2003-311	Compensation for Services	Yes	IRS

TABLE 2
INCOME, IRC § 61(A)

Case Cite	Issue (s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Kikalos v. Comm'r, T.C. Memo. 2004-82	Unreported Income	No	IRS
Knoll v. Comm'r, T.C. Memo 2003-277	Settlement Income IRC § 104(a)(2)	Yes	IRS
Kovacevich v. Comm'r, T.C. Memo. 2003-161	Unreported Income	Yes	IRS
Landers v. Comm'r, T.C. Memo. 2003-300	Interest Income	No	IRS
Laws v. Comm'r, T.C. Summ. Op. 2003-84	Disability / Social Security Payments	Yes	IRS
Le v. Comm'r, T.C. Memo. 2003-219	Diverted Corp. Funds Are Income	Yes	IRS
Leonard v. Comm'r, T.C. Summ. Op. 2004-11	Constructive Pension Distribution	No	IRS
Lewis v. Comm'r, T.C. Summ. Op. 2003-78	Education Assistance Income	Yes	IRS
Lindsey v. Comm'r, T.C. Memo. 2004-113	Settlement Income IRC § 104(a)(2)	No	IRS
Lockmiller v. Comm'r, T.C. Summ. Op. 2003-108	Settlement Income IRC § 104(a)(2)	No	IRS
Maciel, v. Comm'r, T.C. Memo. 2004-28	Unreported Income	Yes	IRS
McCann v. Comm'r, 93 A.F.T.R.2d (RIA) 851 (5th Cir. 2004)	Settlement Income IRC § 104(a)(2)	Yes	Taxpayer
McCarron v. Comm'r, T.C. Summ. Op. 2004-13	Unreported Income	Yes	IRS
McDermott v. Comm'r, T.C. Memo. 2003-269	Gift versus Income	Yes	IRS
McGinty v. Comm'r, T.C. Summ. Op. 2003-74	Employer's Meals, Lodging IRC § 119	Yes	IRS
Medina v. Comm'r, T.C. Summ. Op. 2003-115	Interest Income	No	IRS
Merritt v. Comm'r, T.C. Memo. 2003-187	Fees Paid to Lawyer But Returned to Firm are still Income to Lawyer	No	IRS
Murray v. Comm'r, T.C. Summ. Op. 2004-60	Settlement Income/ Attorney Fees	Yes	IRS
Overby v. Comm'r, T.C. Summ. Op. 2004-5	Unreported Income	Yes	IRS
Oyelola v. Comm'r, T.C. Summ. Op. 2004-28	Settlement Income	Yes	IRS
Palomo v. Comm'r, T.C. Summ. Op. 2003-83	Unreported Income	No	IRS
Pfister v. Comm'r, 359 F.3d 352 (4th Cir. 2004)	Retirement Income	No	IRS
Polone v. Comm'r, T.C. Memo. 2003-339	Settlement Income IRC § 104(a)(2)	No	Split
Price v. Comm'r, T.C. Memo. 2004-103	Unreported Income	Yes	IRS
Raymond v. Comm'r, 355 F.3d 107	Settlement Income IRC § 104(a)(2)/ Attorney Fees	No	IRS
Rayner v. Comm'r, 92 A.f.T.R.2d (RIA) 5151 (5th Cir. 2003)	Frivolous Argument	Yes	IRS
Rice v. Comm'r, T.C. Memo. 2003-208	Unreported Income	Yes	IRS
Roco v. Comm'r, 121 T.C. 160 (2003)	Settlement Income IRC § 104(a)(2)	Yes	IRS
Sadberry v. Comm'r, T.C. Memo. 2004-40	Retirement Income IRC § 402	Yes	IRS
Shaltz v. Comm'r, T.C. Memo. 2003-173	Settlement Income IRC § 104(a)(2)	No	IRS
Sharp v. Comm'r, T.C. Summ. Op. 2004-27	Disability / Social Security Benefits	Yes	IRS
Sowards v. Comm'r, T.C. Memo. 2003-180	Unreported Income	No	IRS
Spurlock v. Comm'r, T.C. Memo. 2003-248	Frivolous Argument	Yes	IRS
Stevens v. Comm'r, T.C. Summ. Op. 2003-163	Unreported income	Yes	Split
Tamberella v. Comm'r, T.C. Memo. 2004-47	Settlement Income IRC § 104(a)(2)	No	IRS
Thompson v. Comm'r, T.C. Memo. 2004-2	Unreported Income	Yes	IRS
Turnidge v. Comm'r, T.C. Memo. 2003-169	Unreported Income	Yes	IRS
Umbach v. Comm'r, 357 F.3d 1108 (10th Cir. 2003)	Foreign Source Income, IRC § 931	No	IRS
Valdes v. Comm'r, T.C. Summ. Op. 2004-19	Unreported Income	Yes	IRS
Venable v. Comm'r, T.C. Memo. 2003-240	Settlement Income IRC § 104(a)(2)	No	IRS
Walker v. Comm'r, T.C. Memo. 2003-335	Capital Gain Income	No	IRS
Weaver v. Comm'r, T.C. Summ. Op. 2003-155	Pension Income / Social Security Benefits or Payments	Yes	IRS
Williams v. Comm'r, T.C. Memo. 2003-216	Unreported Income	Yes	IRS
Wood v. Comm'r, T.C. Memo. 2003-315	Unreported Income	Yes	IRS
Wos v. Comm'r, T.C. Memo. 2003-223	Frivolous Argument	Yes	IRS

TABLE 2
INCOME, IRC § 61(A) (CONT.)

Case Cite	Issue (s)	Pro Se	Decision
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Business Trusts)			
Bonner v. Comm'r, T.C. Summ. Op. 2004-34	Unreported Income	Yes	IRS
Brumsman v. Comm'r, T.C. Memo 2003-291	Unreported income	Yes	IRS
Erickson Post Acquisition, Inc. v. Comm'r, T.C. Memo. 2003-218	Loan versus Income	No	Taxpayer
Fugitt v. Comm'r, T.C. Summ. Op. 2003-98	Unreported Income from Form 1099	Yes	IRS
Grow v. Comm'r, T.C. Op. 2003-114	Unreported Income from Form 1099	Yes	IRS
Hall v. Comm'r, T.C. Summ. Op. 2003-114	Underreporting Income from Form 1099	Yes	IRS
Hamilton v. Comm'r, T.C. Memo. 2004-66	Unreported Income	Yes	IRS
Hamlett v. Comm'r, T.C. Memo. 2004-78	Unreported Income	No	IRS
Mas One Limited Partnership v. Comm'r, 2004 WL 2624711 (6th Cir. 2004), aff'g 271 F. Supp. 2d 1061 (S.D. Ohio 2003)	Partnership Income/ Discharge of Debt	No	IRS
Perry Funeral Home, Inc. v. Comm'r, T.C. Memo. 2003-340	Exclusions from Income	No	Taxpayer
Treu v. Comm'r, T.C. Summ. Op. 2003-125	Unreported Income	Yes	IRS
Schwemmer v. Comm'r, T.C. Summ. Op. 2003-139	Sham Trust	Yes	IRS
Waterfall Farms v. Comm'r, T.C. Memo. 2003-327	Constructive Dividends/Reimbursement of Medical Expenses/Meal & Lodging	No	Split
Estates and Trusts			
Estate of Kanter v. Comm'r, 337 F.3d 833 (7th Cir. 2003)	Unreported Income-Commissions	No	IRS
Estate of Lisle v. Comm'r, 341 F.3d 364 (5th Cir. 2003)	Unreported Income-Commissions	No	IRS

TABLE 3
TRADE OR BUSINESS EXPENSE, IRC § 162

Case Cite	Issue (s)	Pro Se	Decision
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Business Trusts)			
Allen v. Comm'r, T.C. Summ. Op. 2003-97	Sec. 179	Yes	IRS
Assaad v. Comm'r, T.C. Memo. 2003-171	Substantiation	No	IRS
Basin Electric v. Comm'r, T.C. Memo. 2004-109	Sec. 263	No	IRS
Berardi v. IRS, 92 A.F.T.R.2d (RIA) 5669 (3rd Cir. 2003)	Substantiation	Yes	IRS
Blake v. Comm'r, T.C. Summ. Op. 2004-69	Sec. 162	Yes	IRS
Blodgett v. Comm'r, T.C. Memo. 2003-212	Sec. 183	Yes	IRS
Boyd v. Comm'r, 122 T.C. 305 (2004)	Substantiation	No	IRS
Boyd v. Comm'r, T.C. Memo. 2003-286	Substantiation	Yes	IRS
Brewer Quality Homes v. Comm'r, T.C. Memo. 2003-200	Sec. 162	No	Split
Buck v. Comm'r, T.C. Memo. 2003-314	Substantiation	Yes	IRS
Bunney v. Comm'r, T.C. Memo. 2003-233	Sec. 183	No	IRS
Burrus v. Comm'r, T.C. Memo. 2003-285	Sec. 183	No	Taxpayer
Chief Industries, Inc. v. Comm'r, T.C. Memo. 2004-45	Sec. 162	No	Taxpayer
Cottrell v. Comm'r, T.C. Summ. Op. 2003-162	Substantiation	Yes	IRS
Crosson v. Comm'r, T.C. Memo. 2003-70	Sec. 162 and Substantiation	Yes	IRS
Cutts v. Comm'r, T.C. Summ. Op. 2004-8	Sec. 162	No	Split
D'Angelo v. Comm'r, T.C. Memo. 2003-295	Sec. 162	No	Split
Davis v. Comm'r, T.C. Summ. Op. 2004-64	Sec. 162	Yes	IRS
E.J. Harrison and Sons, Inc. v. Comm'r, T.C. Memo. 2003-239	Sec. 162	No	Split
Florida Progress Corp. v. Comm'r, 348 F.3d 954 (11th Cir. 2003)	Sec. 162	No	IRS
Gaylord v. Comm'r, T.C. Memo. 2003-273	Substantiation	Yes	IRS
Griffin v. Comm'r, T.C. Memo. 2004-64	Sec. 162	No	Taxpayer
Grow v. Comm'r, T.C. Summ. Op. 2003-114	Substantiation	Yes	IRS
Guadagno v. Comm'r, T.C. Summ. Op. 2003-88	Sec. 183	Yes	IRS
Hopson v. Comm'r, T.C. Summ. Op. 2004-25	Substantiation	Yes	IRS
Huang v. Comm'r, T.C. Summ. Op. 2003-99	Substantiation	Yes	IRS
Ibarra v. Comm'r, T.C. Summ. Op. 2003-117	Substantiation	Yes	IRS
Illinois Tool Works, Inc. v. Comm'r, 355 F.3d 997 (7th Cir. 2004)	Sec. 195	No	IRS
In re Receiving Estate of Indian Motor Mfg., 92 A.F.T.R.2d (RIA) 5184 (2003)	Sec. 263	No	IRS
Jewett v. Comm'r, T.C. Memo. 2004-26	Substantiation	No	IRS
Jones v. Comm'r, T.C. Summ. Op. 2004-76	Sec. 162 and Substantiation	Yes	Split
Kent v. Comm'r, T.C. Summ. Op. 2004-23	Substantiation	Yes	IRS
Kimm v. Comm'r, T.C. Memo. 2003-215	Sec. 162 and Substantiation	No	IRS
Konchar v. Comm'r, T.C. Summ. Op. 2004-59	Sec. 183	Yes	IRS
Kwan v. Comm'r, T.C. Summ. Op. 2003-119	Sec. 179 and Substantiation	Yes	IRS
Lam v. Comm'r, T.C. Summ. Op. 2003-100	Substantiation	Yes	IRS
Lewis v. Comm'r, T.C. Summ. Op. 2003-78	Sec. 162	Yes	IRS
Maciel v. Comm'r, T.C. Memo. 2004-28	Substantiation	No	IRS
Magassy v. Comm'r, T.C. Memo. 2004-4	Sec. 179	No	IRS
McCarron v. Comm'r, T.C. Summ. Op. 2004-13	Substantiation	Yes	IRS
McGrath v. Comm'r, 92 A.F.T.R.2d (RIA) 6159 (9th Cir. 2003)	Sec. 263	Yes	IRS
McKelvey v. Comm'r, 92 A.F.T.R.2d (RIA) 6312 (9th Cir. 2003)	Sec. 162	Yes	IRS
Megibow v. Comm'r, T.C. Memo. 2004-41	Substantiation	No	IRS
Montoya v. Comm'r, T.C. Summ. Op. 2003-109	Substantiation	Yes	IRS
Moss v. Comm'r, T.C. Summ. Op. 2004-56	Substantiation	Yes	IRS
Northen v. Comm'r, T.C. Summ. Op. 2003-113	Sec. 263	Yes	Taxpayer
Pavelko v. Comm'r, T.C. Summ. Op. 2003-94	Sec. 183	Yes	IRS
Perry v. Comm'r, T.C. Summ. Op. 2003-68	Sec. 183	Yes	IRS
Putnam-Greene Financial v. U.S., 93 A.F.T.R.2d (RIA) 1049 (2004)	Sec. 263	No	Split

TABLE 3
TRADE OR BUSINESS EXPENSE, IRC § 162 (CONT.)

Case Cite	Issue (s)	Pro Se	Decision
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Business Trusts)			
Pyrdum v. Comm'r, T.C. Summ. Op. 2003-146	Sec. 280F and Substantiation	Yes	IRS
Rice v. Comm'r, T.C. Memo. 2003-208	Substantiation	Yes	IRS
Rouse v. Comm'r, T.C. Summ. Op. 2004-49	Sec. 280F and Substantiation	Yes	IRS
Schmidt v. Comm'r, T.C. Memo. 2003-325	Sec. 162	No	Split
Sowards v. Comm'r, T.C. Memo. 2003-180	Substantiation	No	IRS
Square D Company v. Comm'r, 121 T.C. 168 (2003)	Sec. 162 and Sec. 263	No	Split
Swagler v. Comm'r, T.C. Summ. Op. 2004-63	Sec. 280F and Substantiation	Yes	IRS
Townsend Industries v. US, 342 F.3d 890 (8th Cir. 2003)	Sec. 162 and Substantiation	No	Taxpayer
Troutman v. Comm'r, T.C. Memo. 2004-32	Sec. 162	Yes	IRS
Tschetter v. Comm'r, T.C. Memo. 2003-326	Sec. 162	No	Split
Tuck v. Comm'r, T.C. Summ. Op. 2004-10	Sec. 162	Yes	IRS
Viar v. Comm'r, T.C. Summ. Op. 2004-46	Sec. 280F and Substantiation	Yes	Split
Visin v. Comm'r, T.C. Memo. 2003-246	Sec. 179	Yes	IRS
Warren v. Comm'r, T.C. Memo. 2003-175	Sec. 162	Yes	IRS
Waterfall Farms, Inc., v. Comm'r, T.C. Memo. 2003-326	Sec. 162	No	Split
Weaver v. Comm'r, T.C. Memo. 2004-108	Sec. 195	Yes	IRS
Weeldreyer v. Comm'r, T.C. Memo. 2003-324	Sec. 162	No	Split
Wilson v. Comm'r, 92 A.F.T.R.2d (RIA) 5666 (9th Cir. 2003)	Sec. 162	Yes	IRS
Woods v. Comm'r, T.C. Memo. 2004-114	Sec. 280F and Substantiation	Yes	IRS

APPENDIX

TABLE 4
JOINT AND SEVERAL LIABILITY, IRC § 6015

Case Cite	Issue (s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Aranda v. Comm'r, T.C. Memo. 2003-306	Elements for relief	No	IRS
Baranowicz v. Comm'r, T.C. Memo. 2003-274	Elements for relief	Yes	Taxpayer
Barber v. Comm'r, T.C. Summ. Op. 2003-110	Actual or constructive knowledge	Yes	IRS
Barriga v. Comm'r, T.C. Memo. 2004-102	Elements for relief	Yes	IRS
Bartak v. Comm'r, T.C. Memo. 2004-83	Elements for relief	No	IRS
Bartman v. Comm'r, T.C. Memo. 2004-93	Timeliness of claim	No	IRS
Beery v. Comm'r, 122 T.C. 184 (2004)	Federal tax lien; levy	Yes	IRS
Brooks v. Comm'r, T.C. Memo. 2003-166	Actual or constructive knowledge	Yes	IRS
Browda v. Comm'r, T.C. Summ. Op. 2004-16	Actual or constructive knowledge	Yes	Taxpayer
Campbell v. Comm'r, 121 T.C. 290 (2003)	Timeliness of claim	Yes	IRS
Cannon v. U.S., 322 F.Supp.2d 636 (W.D. Pa. 2004)	Timeliness of claim	No	IRS
Cardiff v. Comm'r, T.C. Summ. Op. 2003-142	Undue economic hardship	Yes	Taxpayer
D'Aunay v. Comm'r, T.C. Memo. 2004-79	Elements for relief	Yes	IRS
Demirjian v. Comm'r, T.C. Memo. 2004-22	Elements for relief	No	IRS
Deverna v. Comm'r, T.C. Memo. 2004-80	Abuse of discretion	No	IRS
Dixon v. Comm'r, T.C. Summ. Op. 2003-149	Underlying tax liability	No	IRS
Doyel v. Comm'r, T.C. Memo. 2004-35	Actual or constructive knowledge	No	IRS
Driggers v. Comm'r, T.C. Memo. 2004-76	Timeliness of claim	Yes	IRS
Dutton v. Comm'r, 122 T.C. 133 (2004)	Offer in Compromise	No	IRS
Ellison v. Comm'r, T.C. Memo. 2004-57	Actual or constructive knowledge	No	IRS
Entezam v. Comm'r, T.C. Memo. 2003-253	Actual or constructive knowledge	Yes	IRS
Estate of Kanter v. Comm'r, 337 F.3d 833 (7th Cir. 2003)	Previously litigated issue	No	IRS
Ewing v. Comm'r, 122 T.C. 32 (2004)	Administrative Procedure Act	No	IRS
Favret v. U.S., 92 A.F.T.R.2d (RIA) 7249 (E.D. La. 2003)	Overpayments	No	Taxpayer
Feldman v. Comm'r, T.C. Memo. 2003-201	Elements for relief	No	IRS
Foor v. Comm'r, T.C. Memo. 2004-54	Elements for relief	Yes	Taxpayer
Gilliam v. Comm'r, T.C. Summ. Op. 2004-37	Actual or constructive knowledge	Yes	IRS
Goldin v. Comm'r, T.C. Memo. 2004-129	Timeliness of claim	Yes	IRS
Grow v. Comm'r, T.C. Summ. Op. 2003-114	Elements for relief	Yes	Taxpayer
Haggert v. Comm'r, T.C. Summ. Op. 2003-70	Actual or constructive knowledge	Yes	IRS
Hollis v. Comm'r, T.C. Summ. Op. 2004-30	Understatement of tax	Yes	IRS
Hopkins v. Comm'r, 120 T.C. 451 (2003)	Timeliness of claim	No	Taxpayer
Hopkins v. Comm'r, 121 T.C. 73 (2003)	Actual or constructive knowledge	No	Split
Jones v. U.S., 322 F.Supp.2d 1025 (D. N.D. 2004)	Actual or constructive knowledge	No	Taxpayer
Jonson v. Comm'r, 353 F.3d 1181 (10th Cir. 2003)	Definition of "individual"	No	IRS
Keitz v. Comm'r, T.C. Memo. 2004-74	Elements for relief	Yes	Taxpayer
Leissner v. Comm'r, T.C. Memo. 2003-191	Refund of amount levied	No	Taxpayer
Maier v. Comm'r, 360 F.3d 361 (2nd Cir. 2003)	Non-electing spouses	Yes	IRS
Malone v. Comm'r, T.C. Summ. Op. 2004-9	Divorce decree stipulation	Yes	IRS
Nichols v. Comm'r, T.C. Memo. 2004-61	Actual or constructive knowledge	Yes	IRS
Ogonski v. Comm'r, T.C. Memo. 2004-52	Actual or constructive knowledge	Yes	IRS
Ohrman v. Comm'r, T.C. Memo. 2003-301	Actual or constructive knowledge	No	IRS
Orsino v. Comm'r, T.C. Memo. 2003-174	Actual or constructive knowledge	Yes	IRS
Pahamotang v. Comm'r, T.C. Memo. 2003-177	Opportunity to be heard	Yes	IRS
Pierce v. Comm'r, T.C. Memo. 2003-188	Actual or constructive knowledge	No	IRS
Pierce v. Comm'r, T.C Summ. Op. 2003-126	Actual or constructive knowledge	Yes	IRS
Pless v. Comm'r, T.C. Memo. 2004-24	Elements for relief	Yes	IRS
Price v. Comm'r, T.C. Memo. 2003-226	Duress	Yes	IRS
Rooks v. Comm'r, T.C. Summ. Op. 2003-72	Actual or constructive knowledge	Yes	IRS
Rosenthal v. Comm'r, T.C. Memo. 2004-89	Elements for relief; abuse of discretion	No	Taxpayer

TABLE 1
JOINT AND SEVERAL LIABILITY, IRC § 6015 (CONT.)

Case Cite	Issue (s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Shell v. Comm'r, T.C. Summ. Op. 2003-136	Actual or constructive knowledge	Yes	IRS
Sirianni v. Comm'r, T.C. Memo. 2003-336	Elements for relief	Yes	Taxpayer
Sowards v. Comm'r, T.C. Memo. 2003-180	Actual or constructive knowledge	No	IRS
Thurner v. Comm'r, 121 T.C. 43 (2003)	Previously litigated issue	Yes	Split
Vuxta v. Comm'r, T.C. Memo. 2004-84	Elements for relief; abuse of discretion	No	Split
Wallace v. Comm'r, T.C. Memo. 2003-330	Elements for relief	Yes	IRS
Weight v. Comm'r, T.C. Memo. 2003-214	Actual or constructive knowledge	No	IRS
Weiler v. Comm'r, T.C. Memo. 2003-255	Elements for relief	Yes	Split
Westerhuis v. Comm'r, T.C. Summ. Op. 2003-116	Actual or constructive knowledge	Yes	IRS
Wiggins v. Comm'r, T.C. Summ. Op. 2003-71	Joint return	Yes	IRS
Ziegler v. Comm'r, T.C. Memo. 2003-282	Elements for relief; abuse of discretion	No	IRS
Zoglman v. Comm'r, T.C. Memo. 2003-268	Actual or constructive knowledge	Yes	IRS

TABLE 5
ACCURACY PENALTY FOR NEGLIGENCE, IRC § 6662(B)(1)

Case Cite	Issue (s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Bitker v. Comm'r, T.C. Memo. 2003-209	No reasonable reliance on professional	No	IRS
Hautzinger v. Comm'r, T.C. Memo. 2003-236	No reasonable reliance on professional	Yes	IRS
Hines v. Comm'r, T.C. Summ. Op. 2004-55	No reasonable reliance on professional	Yes	IRS
Hoopengarner v. Comm'r, T.C. Memo 2003-343	No reasonable reliance on professional	No	IRS
Hudspath v. Comm'r, T.C. Memo. 2004-75	No evidence of reasonable cause	Yes	IRS
Israel v. Comm'r, T.C. Memo. 2003-338	No evidence of reasonable cause	Yes	IRS
Jensen v. Comm'r, T.C. Memo. 2003-249	No evidence of reasonable cause	Yes	IRS
Kent v. Comm'r, T.C. Summ. Op. 2004-23	No substantiation for deductions	Yes	IRS
Kerr v. Comm'r, T.C. Memo. 2003-311	No explanation for omission of income	Yes	IRS
Kikalos v. Comm'r, T. C. Memo. 2004-82	Inadequate records	No	IRS
Knoll v. Comm'r, T.C. Memo. 2003-277	Reasonable basis for treatment of advance payments, not for lump sum	No	Split
McDermott v. Comm'r, T.C. Memo. 2003-269	Nontaxable bank deposits	Yes	Taxpayer
Merritt v. Comm'r, T.C. Memo. 2003-187	Reasonable reliance on professional	No	Taxpayer
Polone v. Comm'r, T.C. Memo. 2003-339	Reasonable reliance on professional	No	Taxpayer
Schwemmer v. Comm'r, T.C. Summ. Op. 2003-138	No reasonable cause in sham trust	Yes	IRS
Schwemmer v. Comm'r, T.C. Summ. Op. 2003-139	No reasonable cause shown	Yes	IRS
Sharp v. Comm'r, T.C. Summ. Op. 2004-27	Reasonable attempt to determine tax	Yes	Taxpayer
Spuler v. Comm'r, T.C. Summ. Op. 2003-131	No good faith shown for deductions	Yes	IRS
Stewart v. Comm'r, T.C. Summ. Op. 2003-101	Reasonable reliance on professional for	Yes	Split
Tamberella v. Comm'r, T.C. Memo. 2004-47	1 out of 2 charitable donations Mental illness not reasonable cause	No	IRS
Treu v. Comm'r, T.C. Summ. Op. 2003-125	Ignorance of amount is no excuse	Yes	IRS
Walker v. Comm'r, T.C. Memo. 2003-335	Taxpayer properly advised by representative	No	IRS
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)			
Assaad v. Comm'r, T.C. Memo. 2003-171	Loss of records not reasonable cause	No	IRS
Beery v. Comm'r, T.C. Memo. 2003-331	No basis for NOL carry forward	Yes	IRS
Buck v. Comm'r, T.C. Memo. 2003-314	Substantiation not met 7491(a)(2)(A)	Yes	IRS
Burrus v. Comm'r, T.C. Memo. 2003-285	Reasonable conduct on farm activities but no substantiation on other items	No	Split
Corduan v. Comm'r, T.C. Summ. Op. 2004-51	No reasonable cause or good faith	Yes	IRS
Crosson v. Comm'r, T.C. Memo. 2003-170	Lack of substantiation	Yes	IRS
Cutts v. Comm'r, T.C. Summ. Op. 2004-8	No explanation as to inter-business loan	No	IRS
Demetree v. Comm'r, T.C. Memo. 2003-323	Inadequate records	No	IRS
Diers v. Comm'r, T.C. Memo. 2003-229	Unreported income/ Exp. substantiation	Yes	IRS
Garbini v. Comm'r, T.C. Summ. Op. 2004-7	IRC § 183 Farm activity	No	IRS
Gaylord v. Comm'r, T.C. Memo. 2003-273	Lack of substantiation	Yes	IRS
Haggart v. Comm'r, T.C. Summ. Op. 2003-70	Lack of substantiation	Yes	IRS
Hardin v. Comm'r, T.C. Memo. 2004-77	Lack of substantiation	No	IRS
Hawkins v. Comm'r, T.C. Summ. Op. 2003-154	Inadequate records, no substantiation	Yes	IRS
Henry v. Comm'r, T.C. Summ. Op. 2003-104	Reasonable cause on tax years where professional relied upon	Yes	Split
Kimm v. Comm'r, T.C. Memo. 2003-215	Reasonable reliance on professional	No	Taxpayer
Kovacevich v. Comm'r, T.C. Memo 2003-161	Did not provide professional with accurate information for reliance	No	IRS
Kwan v. Comm'r, T.C. Summ. Op. 2003-119	No substantiation of deductions	Yes	IRS
Lam v. Comm'r, T.C. Summ. Op. 2003-100	No substantiation of deductions	Yes	IRS
McCarron v. Comm'r, T.C. Summ. Op. 2004-13	Tax professionals held to high standard	Yes	IRS

TABLE 5
ACCURACY PENALTY FOR NEGLIGENCE, IRC § 6662(B)(1) (CONT.)

Case Cite	Issue (s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Megibow v. Comm'r, T.C. Memo. 2004-41	Clear disregard of rules and regulations	No	IRS
Overby v. Comm'r, T.C. Summ. Op. 2004-5	No cause for unreported income	Yes	IRS
Perry Funeral Home, Inc. v. Comm'r, T.C. Memo. 2003-340	Taxpayer prevails on pre-paid contracts method of accounting; no reasonable cause on conceded items	No	Split
Palomo v. Comm'r, T.C. Summ. Op. 2003-83	Attorney held to higher standard	No	IRS
Pyrdum v. Comm'r, T.C. Summ. Op. 2003-146	Deductions clearly without authority	Yes	IRS
Schmidt v. Comm'r, T.C. Memo. 2003-325	No reasonable cause offered	No	IRS
Sowards v. Comm'r, T.C. Memo. 2003-180	Disregard of law warrants penalty	No	IRS
Tschetter v. Comm'r, T.C. Memo. 2003-326	Taxpayer offers no evidence on penalty	No	IRS
Viar v. Comm'r, T.C. Summ. Op. 2004-46	Medical problems no excuse	Yes	IRS
Waterfall Farms, Inc. v. Comm'r, T.C. Memo. 2003-327	Taxpayer offers no evidence on penalty	No	IRS
Weeldreyer v. Comm'r, T.C. Memo. 2003-324	Taxpayer offers no evidence on penalty	No	IRS
Western Management, Inc. v. Comm'r, T.C. Memo. 2003-162	Taxpayer's legal arguments frivolous	No	IRS

TABLE 6
FAILURE TO FILE PENALTY, IRC § 6651(A)

Case Cite	Issue (s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Arnold v. Comm'r, T. C. Memo. 2003-259	Persuasive evidence not presented	Yes	Split
Cavender v. Comm'r, T.C. Memo. 2004-33	No argument presented	No	IRS
Cooper v. Comm'r, T.C. Summ. Op. 2003-168	No argument presented	Yes	IRS
Crittenden v. Comm'r, T.C. Memo. 2003-186	Schedule/travel as reasonable cause	Yes	IRS
Gilmore v. Comm'r, T.C. Summ. Op. 2004-50	No evidence presented	Yes	IRS
Harkey v. Comm'r, T.C. Summ. Op. 2003-87	No argument or evidence presented	Yes	IRS
Israel v. Comm'r, T.C. Memo. 2003-338	No evidence presented	Yes	IRS
Jacobson v. Comm'r, T.C. Memo. 2003-227	Did not posses information to file return	Yes	IRS
Johnston v. Comm'r, T.C. Memo. 2004-107	No evidence presented	Yes	IRS
Lindsey v. Comm'r, T.C. Memo. 2004-113	No argument presented	No	IRS
Overton v. Comm'r, T.C. Memo. 2003-344	Invalid returns with altered jurat filed	Yes	IRS
Secapture v. Comm'r, T.C. Memo. 2004-18	No evidence of filing return presented	No	IRS
Spuler v. Comm'r, T.C. Summ. Op. 2003-131	Illness and divorce prevented tax filing	Yes	IRS
Suri v. Comm'r, T.C. Memo. 2004-71	Filing requirement questioned	Yes	IRS
Tamberella v. Comm'r, T.C. Memo. 2004-47	Mental illness as reasonable cause	No	IRS
Thompson v. Comm'r, T.C. Memo. 2004-2	Filing requirement questioned	Yes	IRS
Tobkin v. Comm'r, T.C. Summ. Op. 2004-42	Depression / Advice of tax practitioner	Yes	IRS
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)			
Assaad v. Comm'r, T.C. Memo. 2003-171	Reliance on tax practitioner to file return	No	IRS
Boyd v. Comm'r, T.C. Memo. 2003-286	Reasonable cause not established	Yes	IRS
Burrus v. Comm'r, T.C. Memo. 2003-285	Reliance on tax practitioner to file return	No	IRS
Charlotte's Office Boutique v. Comm'r, 121 T.C. 89 (2003)	Reasonable cause not established	No	IRS
Demetree v. Comm'r, T.C. Memo. 2003-323	No argument or evidence presented	No	IRS
Dotson v. Comm'r, T.C. Summ. Op. 2003-151	Claim of no tax liability under the law	Yes	IRS
Godwin v. Comm'r, T.C. Memo. 2003-289	Casualty to home/office prevented filing	Yes	IRS
Hawkins v. Comm'r, T.C. Summ. Op. 2003-154	Claimed tax payments covered liability	Yes	IRS
Hawkins v. Comm'r, T.C. Memo. 2003-181	Religious beliefs restrict filing returns	Yes	IRS
Hoopengarner v. Comm'r, T.C. Memo. 2003-343	No argument or evidence presented	No	IRS
Huffman, Carter & Hunt, Inc. v. U.S., 93 A.F.T.R.2d (RIA) 1869 (S.D. Ohio 2004)	Embezzlement as reasonable cause	No	IRS
Kumpel v. Comm'r, T.C. Memo. 2003-265	Objected to the obligations as employer	Yes	IRS
Maintenance, Painting & Constr., v. Comm'r, T.C. Memo. 2003-270	No evidence presented	No	IRS
McCarron v. Comm'r, T.C. Summ. Op. 2004-13	No argument or evidence presented	Yes	IRS
Mehner v. Comm'r, T.C. Memo. 2003-203	No argument or evidence presented	Yes	IRS
Mendes v. Comm'r, 121 T.C. 308 (2003)	Reliance on tax practitioner to file return	Yes	IRS
Merritt v. Comm'r, T.C. Memo. 2003-187	Reliance on tax practitioner to file return	No	IRS
Ozaki v. Comm'r, T.C. Memo. 2003-213	Mental illness as reasonable cause	Yes	IRS
Prince v. Comm'r, T.C. Memo. 2003-247	No evidence presented	Yes	IRS
Smith v. Comm'r, T.C. Memo. 2003-266	Dismissal for failure to prosecute	Yes	IRS
Spurlock v. Comm'r, T.C. Memo. 2003-248	Claim of no tax liability under the law	Yes	IRS
Treu v. Comm'r, T.C. Summ. Op. 2003-125	No argument or evidence presented	Yes	IRS
Trowbridge v. Comm'r, T.C. Memo. 2003-164	Altered jurat line created invalid return	Yes	IRS
Trowbridge v. Comm'r, T.C. Memo. 2003-165	Altered jurat line created invalid return	Yes	IRS
Turnidge v. Comm'r, T.C. Memo. 2003-169	No evidence presented	Yes	IRS
Weaver v. Comm'r, T.C. Memo. 2004-108	No argument or evidence presented	Yes	IRS
Williams v. Comm'r, T.C. Memo. 2003-216	No argument or evidence presented	Yes	IRS
Wood v. Comm'r, T.C. Memo. 2003-315	No argument or evidence presented	Yes	IRS
Wos v. Comm'r, T.C. Memo. 2003-223	Unsigned return filed but not accepted	Yes	IRS
Zacky v. Comm'r, T.C. Memo. 2004-130	Could not afford return preparation fees	Yes	IRS

TABLE 7
FAMILY STATUS ISSUES, IRC §§ 2, 21, 24 AND 151

Case Cite	Issue (s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Ahmed v. Comm'r, T.C. Summ. Op. 2004-20	Filing Status	Yes	IRS
Betancourt v. Comm'r, T.C. Summ. Op. 2004-61	Filing Status, Child Tax Credit, Dependency Exemp.	Yes	IRS
Brinson v. Comm'r, T.C. Summ. Op. 2003-89	Filing Status, Dependency Exemp.	Yes	IRS
Brissett v. Comm'r, T.C. Memo. 2003-310	Dependency Exemp.	Yes	IRS
Burke v. Comm'r, T.C. Summ. Op. 2003-147	Dependency Exemp.	No	IRS
Cantrell v. Comm'r, T. C. Summ. Op. 2004-52	Filing Status, Child and Dependent-Care Credit, Child Tax Credit, Dependency Exemp.	Yes	Split
Cavender v. Comm'r, T.C. Memo. 2004-33	Dependency Exemp.	No	IRS
Corduan v. Comm'r, T.C. Summ. Op. 2004-51	Filing Status, Dependency Exemp.	Yes	IRS
Crowell v. Comm'r, T.C. Summ. Op. 2003-134	Child and Dependent Care Credit, Dependency Exemp.	Yes	IRS
Dail v. Comm'r, T.C. Memo. 2003-211	Filing Status, Dependency Exemp.	Yes	Taxpayer
	Child Tax Credit	Yes	IRS
Echevarria v. Comm'r, T.C. Summ. Op. 2003-92	Filing Status	Yes	IRS
Elsawah v. Comm'r, T.C. Summ. Op.2004-33	Fling Status	Yes	IRS
Francisco v. Comm'r, T. C. Summ. Op. 2004-4	Dependency Exemp.	Yes	IRS
Gaylord v. Comm'r, T.C. Memo. 2003-273 *Gilmore v. Comm'r*, T.C. Summ. Op. 2004-38	Filing Status, Child Tax Credit, Dependency Exemp.	Yes	IRS
Hamilton v. Comm'r, T.C. Summ. Op. 2003-85	Filing Status, Child Tax Credit, Dependency Exemp.	Yes	Split
Hernandez v. Comm'r, T.C. Summ. Op. 2003-144	Filing Status, Child Tax Credit, Dependency Exemp.	Yes	IRS
Howard v. Comm'r, T. C. Summ. Op. 2003-124	Dependency Exemp.	Yes	IRS
Izac v. Comm'r, T.C. Summ. Op. 2003-86	Child Tax Credit, Dependency Exemp.	Yes	IRS
James v. Comm'r, T.C. Summ. Op. 2003-118	Dependency Exemp.	Yes	IRS
Kent v. Comm'r, T.C. Summ. Op. 2004-23	Filing Status, Dependency Exemp.	Yes	IRS
King v. Comm'r, 121 T.C. 245 (2003)	Dependency Exemp.	Yes	Split
Linton v. Comm'r, T.C. Memo. 2003-160	Filing Status, Dependency Exemp.	Yes	IRS
Lisi v. Comm'r, T.C. Summ. Op. 2003-132	Dependency Exemp.	No	IRS
Martinez v. Comm'r, T.C. Summ. Op. 2003-128	Child Tax Credit, Dependency Exemp.	Yes	IRS
Mbanu v. Comm'r, T.C. Summ. Op. 2004-58	Filing Status	Yes	IRS
McCullar v. Comm'r, T.C. Memo. 2003-272	Filing Status, Child Tax Credit, Dependency Exemp.	Yes	Taxpayer
Mehner v. Comm'r, T.C. Memo. 2003-203	Dependency Exemp.	Yes	IRS
Mendes v. Comm'r, 121 T.C. 308 (2003)	Dependency Exemp.	Yes	IRS
Molina v. Comm'r, T.C. Memo. 2003-254	Filing Status, Dependency Exemp.	Yes	Taxpayer
Mudd v. Comm'r, T.C. Summ. Op. 2004-1	Dependency Exemp.	Yes	Taxpayer
Planko v. Comm'r, T.C. Summ. Op. 2003-105	Filing Status, Dependency Exemp.	Yes	IRS
Prince v. Comm'r, T.C. Memo. 2003-247	Filing Status, Dependency Exemp.	Yes	IRS
Rice v. Comm'r, T.C. Memo. 2003-208	Dependency Exemp.	Yes	IRS
Santilla v. Comm'r, T.C. Summ. Op. 2004-24	Dependency Exemp.	Yes	IRS
Schroeder v. Comm'r, T.C. Summ. Op. 2003-80	Child Tax Credit, Dependency Exemp.	Yes	IRS
St. Hilaire v. Comm'r, T.C. Summ. Op. 2003-102	Filing Status, Child and Dependent Care Credit, Child Tax Credit, Dependency Exemp.	Yes	Split
Stone v. Comm'r, T.C. Summ. Op. 2004-43	Child Tax Credit, Dependency Exemp.	Yes	IRS
Taylor v. Comm'r, T.C. Summ. Op. 2003-133	Filing Status, Dependency Exemp.	Yes	IRS
Thompson v. Comm'r, T.C. Summ. Op. 2003-73	Filing Status, Dependency Exemp.	Yes	IRS
Webb-Reed v. Comm'r, T.C. Summ. Op. 2004-6	Filing Status, Child and Dependent Care Credit, Child Tax Credit, Dependency Exemp.	Yes	IRS
Womack v. Comm'r, T.C. Memo. 2003-182	Dependency Exemp.	Yes	Taxpayer
Young v. Comm'r, T.C. Summ. Op. 2003-170	Child Tax Credit	Yes	IRS

APPENDIX

TABLE 8
FRIVOLOUS ISSUES PENALTY, IRC § 6673

Case Cite	Issue (s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Banat v. Comm'r, 92 A.F.T.R.2d (RIA) 7075 (2nd Cir. 2002)	Constitutionality of Tax-Frivolous	Yes	IRS
Bethea v. Comm'r, T.C. Memo. 2003-278	IRS Failure to Verify Tax-Frivolous	No	IRS
Brashear v. Comm'r, T.C. Memo. 2003-196	IRS Authority to Tax-Frivolous	Yes	IRS
Brodman v. Comm'r, T.C. Memo. 2003-230	IRS Failure to Verify Tax –Frivolous	No	IRS
Brown v. Comm'r, T.C. Memo. 2003-261	IRS Failure to Verify Tax-Frivolous	No	IRS
Carskadon v. Comm'r, T.C. Memo. 2003-237	Wages Are Not Income-Frivolous	Yes	IRS
Cipolla v. Comm'r, T.C. Memo. 2004-6	Arguments Only for Delay	Yes	IRS
Curtis v. Comm'r, 92 A.F.T.R.2d (RIA) 5664 (9th Cir. 2003)	Taxability of Rental Income	Yes	IRS
Deputy v. Comm'r, T.C. Memo. 2003-210	Arguments Only for Delay	Yes	IRS
Dunham v. Comm'r, T.C. Memo. 2003-260	No Valid Assessment-Frivolous	No	IRS
Frey v. Comm'r, T.C. Memo. 2004-87	No Valid Assessment-Frivolous	Yes	IRS
Green v. Comm'r, T.C. Memo. 2003-264	No Authority to Tax-Frivolous	Yes	IRS
Haines v. Comm'r, 92 A.F.T.R.2d (RIA) 5939 (9th Cir. 2003)	Frivolous Issues	Yes	IRS
Hawkins v. Comm'r, T.C. Memo. 2003-181	Federal Income Tax Violates Religious Freedom Restoration Act	Yes	Taxpayer
Horton v. Comm'r, T.C. Memo. 2003-197	Not Subject to Tax-Frivolous/Delay	Yes	IRS
Israel v. Comm'r, T.C. Memo. 2003-338	Notice of Deficiency Invalid-Frivolous	Yes	IRS
Israel v. Comm'r, T.C. Memo. 2003-198, *aff'd*, 93 A.F.T.R.2d (RIA) 1824 (7th Cir. 2004)	Failure to Send Valid Statutory Notices	Yes	IRS
Johnston v. Comm'r, T.C. Memo. 2004-107	No Deficiency w/o Return-Frivolous	Yes	IRS
Kemper v. Comm'r, T.C. Memo. 2003-195	Arguments Only For Delay	Yes	IRS
Kolker v. Comm'r, 93 A.F.T.R.2d 2004 (RIA) 2392 (9th Cir. 2004)	Frivolous Appeal Penalty	Yes	IRS
Moore v. Comm'r, T.C. Memo. 2003-307	AMT Unconstitutional-Not Frivolous	Yes	Taxpayer
Rayner v. Comm'r, 92 A.F.T.R.2d (RIA) 5151 (5th Cir. 2003)	Pension Distrib. Not Income-Frivolous	Yes	IRS
Robinson v. Comm'r, 92 A.F.T.R.2d (RIA) 5968 (4th Cir. 2003)	Frivolous Issues	Yes	IRS
Spurlock v. Comm'r, T.C. Memo. 2003-248	Not Required to File Return-Frivolous	Yes	IRS
Suri v. Comm'r, T.C. Memo. 2004-71	Refusal to Meet with IRS; Delay	Yes	IRS
Business Taxpayers (Sole Proprietorships including Schedule C and/or F, Schedule E, Corporations, Partnerships and Trusts)			
Carey v. Comm'r, T.C. Memo. 2003-281	No Earned Income-Frivolous	Yes	IRS
Hardin v. Comm'r, T.C. Memo. 2004-77	Arguments Only for Delay	Yes	IRS
Hathaway v. Comm'r, T.C. Memo. 2004-15	Income is Not Taxable-Frivolous	Yes	IRS
Heaphy v. Comm'r, T.C. Memo. 2004-48	Appeal Solely for Delay	Yes	IRS
Jensen v. Comm'r, T.C. Memo. 2004-120	IRS Failure to Verify Tax-Frivolous	Yes	IRS
Liti v. Comm'r, 93 A.F.T.R.2d (RIA) 382 (9th Cir. 2003)	IRS Position Not Frivolous	No	IRS
Pepper Pot Trust v. Comm'r, T.C. Memo. 2003-287	Authority of IRS to Tax-Frivolous	Yes	IRS
Trowbridge v. Comm'r, T.C. Memo. 2003-164	Frivolous Arguments	Yes	IRS
Trowbridge v. Comm'r, T.C. Memo. 2003-165	Positions Solely for Delay	Yes	IRS
Wos v. Comm'r, T.C. Memo. 2003-223	Net Profit Not Taxable	Yes	IRS

TABLE 9
EARNED INCOME TAX CREDIT (EITC), IRC § 32

Case Cite	Issue (s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Israel v. U.S., 356 F.3d 221 (2nd Circuit 2004)	EITC deemed paid w/in 3 yrs of refund	No	IRS
Favret v. U.S., 92 A.F.T.R.2d (RIA) 7249 (E.D. La. 2003)	EITC applied to prior tax liability	No	Taxpayer
In re Broadus, 93 A.F.T.R.2d (RIA) 1972 (Bankr. D. Colo. 2004)	Claiming separate EITC	No	IRS
In re Sohn, 300 B.R. 332 (D. Minn. 2003)	EITC anticipated refund is "disposable income" in the Chapter 13 context	No	Objection Sustained
Gallardo v. Comm'r, T.C. Summ. Op. 2004-72	EITC, dependency exemp. , filing status	Yes	IRS
Mbanu v. Comm'r, T.C. Summ. Op. 2004-58	EITC, Head of Household filing status	Yes	IRS
Bentancourt v. Comm'r, T.C. Summ. Op. 2004-61	EITC, filing status, dependency exemp.	Yes	IRS
Cantrell v. Comm'r, T.C. Summ. Op. 2004-52	EITC, filing status, dependency exemp.	Yes	Split
Gilmore v. Comm'r, T.C. Summ. Op. 2004-38	EITC, filing status, dependency exemp.	Yes	Split
Robertson v. Comm'r, T.C. Memo. 2004-072	EITC eligibility in collection due process	Yes	Split
Elsawah v. Comm'r, T.C. Memo. 2004-33	EITC, Head of Household filing status	Yes	IRS
Voight v. Comm'r, T.C. Memo. 2004-62	EITC, dependency exemptions	Yes	Split
Ahmed v. Comm'r, T.C. Summ. Op. 2004-20	EITC, filing status, dependency exemp.	Yes	IRS
Carter v. Comm'r, T.C. Summ. Op. 2004-18	EITC with qualifying child	Yes	IRS
Webb-Reed v. Comm'r, T.C. Summ. Op. 2004-6	EITC, filing status, dependency exemp.	Yes	IRS
Francisco v. Comm'r, T.C. Summ. Op. 2004-4	EITC, Head of Household filing status	Yes	IRS
Nguyen v. Comm'r, T.C. Memo. 2003-313	EITC, filing status, dependency exemp.	No	IRS
Hernandez v. Comm'r, T.C. Summ. Op. 2003-144	EITC, filing status, dependency exemp.	Yes	IRS
Cisse v. Comm'r, T.C. Summ. Op. 2003-143	EITC with qualifying child	Yes	IRS
Taylor v. Comm'r, T.C. Summ. Op. 2003-133	EITC, filing status, dependency exemp.	Yes	IRS
Kennedy v. Comm'r, T.C. Summ. Op. 2003-121	EITC with qualifying child	Yes	IRS
Elliott v. Comm'r, T.C. Summ. Op. 2003-106	EITC with qualifying child	No	IRS
St. Hilaire v. Comm'r, T.C. Summ. Op. 2003-102	EITC, filing status, dependency exemp.	Yes	Split
Echevarria v. Comm'r, T.C. Summ. Op. 2003-92	EITC , Child Tax Credit	Yes	IRS
Brinson v. Comm'r, T.C. Summ. Op. 2003-89	EITC, filing status, dependency exemp.	Yes	IRS
Hamilton v. Comm'r, T.C. Summ. Op. 2003-85	EITC, filing status, dependency exemp.	Yes	Split
Thompson v. Comm'r, T.C. Summ. Op. 2003-73	EITC, filing status, dependency exemp.	Yes	IRS
Linton v. Comm'r, T.C. Memo. 2003-160	EITC, filing status, dependency exemp.	Yes	IRS

TABLE 10
TRUST FUND RECOVERY PENALTY (TFRP), IRC § 6672

Case Cite	Issue (s)	Pro Se	Decision
Individual Taxpayers (Issues Other Than Business)			
Bell v. U.S., 355 F.3d 387 (6th Cir. 2004)	Responsibility and willfulness	No	IRS
In re Bowman, 93 A.F.T.R.2d (RIA) 1504 (Bankr. D. Neb. 2003)	Responsibility determination	No	Taxpayer
In re Brown, 92 A.F.T.R.2d (RIA) 6000 (Bankr. D. Oregon 2003)	Applicability of penalty tax	No	IRS
In re Charbrand, 92 A.F.T.R.2d (RIA) 6891 (Bankr. S.D. Tex. 2003)	Responsibility and willfulness; notice	No	IRS
U.S. v. Cook, 93 A.F.T.R.2d (RIA) 1597 (E.D. Pa. 2004)	Expiration of collection statute	No	IRS
Farkas v. U.S., 57 Fed.Cl. 134 (2003)	Responsibility and willfulness	No	Split
Ferguson v. U.S., 317 F.Supp.2d 945 (S.D. Iowa 2004)	Responsibility and willfulness	No	IRS
Gitlow v. U.S., 93 A.F.T.R.2d (RIA) 2493 (S.D.N.Y. 2004)	Assessment computation; responsibility	Yes	IRS
Gnifkowski v. U.S., 93 A.F.T.R.2d (RIA) 1159 (D. Minn. 2004)	Statute of limitations	No	IRS
In re Groth, 92 A.F.T.R.2d (RIA) 6318 (Bankr. D.N.D. 2003)	Responsibility; joint and several liability	No	IRS
Holmes v. U.S., 93 A.F.T.R.2d (RIA) 2450 (S.D. Tex. 2004)	Responsibility; collection from others	No	IRS
In re Howard, 92 A.F.T.R.2d (RIA) 6389 (Bankr. E.D.N.C. 2003)	Responsibility determination	No	IRS
In re Lartz, 93 A.F.T.R.2d (RIA) 378 (M.D. Penn. 2003)	Responsibility and willfulness	No	Taxpayer
Layne v. U.S., 92 A.F.T.R.2d (RIA) 7035 (W.D. Va. 2003)	Responsibility determination	No	Split
Leiter v. U.S., 93 A.F.T.R.2d (RIA) 793 (D. Kan. 2004)	Amount of penalty assessed	No	IRS
Lyon v. U.S., 92 A.F.T.R.2d (RIA) 5029 (4th Cir. 2003)	Responsibility and willfulness	No	IRS
In re Marino, 93 A.F.T.R.2d (RIA) 1176 (Bankr. M.D. Fla. 2004)	Responsibility and willfulness	No	Taxpayer
In re Marino, 93 A.F.T.R.2d (RIA) 2435 (M.D. Fla. 2004)	Responsibility and willfulness	No	IRS
U.S. v. Mitchell, 92 A.F.T.R.2d (RIA) 7392 (3rd Cir. 2003)	Responsibility and willfulness	No	IRS
Moulton v. U.S., 92 A.F.T.R.2d (RIA) 7241 (D. Mass. 2003)	Responsibility and willfulness	No	Split
U.S. v. Roberts, 92 A.F.T.R.2d (RIA) 6237 (D.N.J. 2003)	Responsibility and willfulness	Yes	IRS
U.S. v. Schock, 92 A.F.T.R.2d (RIA) 5162 (D. Del. 2003)	Responsibility and willfulness	No	IRS
U.S. v. Sibbrel, 92 A.F.T.R.2d (RIA) 7204 (9th Cir. 2003)	Responsibility determination	No	Taxpayer
U.S. v. Smith, 93 A.F.T.R.2d (RIA) 2444 (D. Nev. 2004)	Responsibility and willfulness	Yes	Taxpayer
Stuart v. U.S., 337 F.3d 31 (1st Cir. 2003)	Responsibility and willfulness	No	IRS
Thosteson v. U.S., 331 F.3d 1294 (11th Cir. 2003)	Responsibility and willfulness	No	IRS

ACRONYM GLOSSARY - ANNUAL REPORT TO CONGRESS 2004

Acronym	Definition
AAS	Automated Answering System
ABA	American Bar Association
ACCE	Appeals, Counsel, Collection and Examination
ACS	Automated Collection System
ACTC	Advance Child Tax Credit
ADR	Alternative Dispute Resolution
ADRA	Alternative Dispute Resolution Act
AEITC	Advanced Earned Income Tax Credit
AGI	Adjusted Gross Income
AICPA	American Institute of Certified Public Accountants
AIMS	Audit Information Management System
AMT	Alternative Minimum Tax
APA	Administrative Procedure Act
ARC	Annual Report to Congress
AQMS	Appeals Quality Measurement System
ASED	Assessment Statute Expiration Date
ASFR	Automated Substitute for Return
ATAO	Application for Taxpayer Assistance Order
AUR	Automated Underreporter
AWSS	Agency Wide Shared Services
BMF	Business Master File
C&L	Communications & Liaison
CAS	Customer Account Services
CAWR	Combined Annual Wage Reporting Program
CBO	Congressional Budget Office
CC	Chief Counsel
CCR	Central Contractor Registration
CDP	Collection Due Process
CERCA	Council for Electronic Revenue Communication Advancement
CID	Criminal Investigation Division
CIP	Compliance Initiative Projects
CIS	Correspondence Imaging System
CNC	Currently Not Collectible
COIC	Centralized Offer In Compromise Program
CONOPS	Concept of Operations
CPE	Continuing Professional Education
CRIS	Compliance Research Information System
CSED	Collection Statute Expiration Date
CSI	Campus Specialization Initiative
CSR	Customer Service Representative
CTC	Child Tax Credit
CTEC	California Tax Education Council
DATC	Doubt As To Collectibility
DATL	Doubt As To Liability
DDP	Daily Delinquency Penalty
DI	Debt Indicator Program

ACRONYM GLOSSARY - ANNUAL REPORT TO CONGRESS 2004

Acronym	Definition
DIF	Discriminant Inventory Function
DOD	Department of Defense
DPT	Dynamic Project Team
ECO	Equitable Consideration Offer
EDS	Exempt Determinations System
EGTRRA	Economic Growth and Tax Relief Reconciliation Act
EFTPS	Electronic Filing Tax Payment System
EIN	Employer Identification Number
EITC	Earned Income Tax Credit
ELS	Electronic Lodgment Service
EO	Exempt Organization
EP	Employee Plans
EQRS	Embedded Quality Review System
ERIS	Enforcement Revenue Information System
ERO	Electronic Return Originator
ERSA	Employee Retirement Savings Account
ES	Estimated Tax Payments
ESA	Educational Savings Account
ESL	English as a Second Language
ETA	Effective Tax Administration
ETLA	Electronic Tax Law Assistance
FA	Field Assistance
FAOPS	Field Assistance Operating Procedures
FICA	Federal Insurance Contribution Act
FMS	Financial Management Service
FOIA	Freedom Of Information Act
FPDC	Federal Procurement Data Center
FPDS	Federal Procurement Data System
FPLP	Federal Payment Levy Program
FSLG	Federal, State and Local Governments (Office of)
FTD	Federal Tax Deposit
FTE	Full Time Equivalent
FTM	Fast Track Mediation
FTS	Fast Track Settlement
FY	Fiscal Year
GAO	Government Accountability Office or General Accounting Office
GO	Government Entities
HSC	Hope Scholarship Credit
IDFP	IRS Directory for Practitioners
IDRS	Integrated Data Retrieval System
IDS	Inventory Delivery System
IMF	Individual Master File
INS	Immigration and Naturalization Service
IOD	Interactive Organizational Directory

ACRONYM GLOSSARY - ANNUAL REPORT TO CONGRESS 2004

Acronym	Definition
IR	Inland Revenue
IRC	Internal Revenue Code
IRM	Internal Revenue Manual
IRMF	Information Returns Master File
IRP	Information Return Program
IRS	Internal Revenue Service
IRSAC	Internal Revenue Service Advisory Council
ISO	Incentive Stock Option
ISN	Internet Service Node
IRSAC	Internal Revenue Service Advisory Committee
ISP	Industry Specialization Program
ISRP	Integrated Submission and Remittance Processing
ITIN	Individual Taxpayer Identification Number
LEP	Limited English Proficiency
LITC	Low Income Taxpayer Clinic
LLC	Lifetime Learning Credit
LMSB	Large & Mid-Sized Business Operating Division
LOS	Level of Service
LRF	Last Return Filed
LSA	Lifetime Savings Account
LTA	Local Taxpayer Advocate
MAGI	Modified Adjusted Gross Income
MFT	Master File Transaction Code
MITS	Modernization and Information Technology Services
NAEA	National Association of Enrolled Agents
NAPT	National Association of Tax Professionals
NASD	National Association of Securities Dealers
NCAG	Notice Communication Advisory Group
NFTL	Notice of Federal Tax Lien
NMF	Non-Master File
NPIIT	Notice Process Improvement Initiative Team
NRP	National Research Program
NSG	Notice Support Group
NTA	National Taxpayer Advocate
OAR	Operations Assistance Request
OBRA	Omnibus Budget Reconciliation Act of 1989
OIC	Offer in Compromise
OMB	Office of Management and Budget
OPERA	Office of Program Evaluation, Research, & Analysis
ORG	Organization
PENAPP	Penalty Appeals
PMG	Publication Method Guide
PRO	Problem Resolution Officer
PRP	Problem Resolution Program
PRPCIT	Problem Resolution Program Case Identification Tracking

3
APPENDIX

Acronym	Definition
QRP	Questionable Refund Program
RAC	Refund Anticipation Check
RAL	Refund Anticipation Loan
RCP	Reasonable Collection Potential
RGS	Report Generating Software
ROFT	Record of Federal Tax Liability
RRA 98	(Internal Revenue Service) Reform and Restructuring Act of 1998
RPP	Return Preparer Program
RPAT	Return Preparer Assessment Tool
RSA	Retirement Savings Account
SAC	Special Advisory Committee
SAMS	Systemic Advocacy Management System
SB/SE	Small Business/Self Employed Operating Division
SBJPA	Small Business Job Protection Act
SERP	Servicewide Electronic Research Program
SFR	Substitute for Return
SPEC	Stakeholder, Partnerships, Education & Communication
SPOC	Single Point of Contact
SSA	Social Security Administration
SSN	Social Security Number
TAC	Taxpayer Assistance Center
TAMIS	Taxpayer Advocate Management Information System
TAP	Taxpayer Advocacy Panel
TAS	Taxpayer Advocate Service
TEC	Taxpayer Education & Communication
TCE	Tax Counseling for the Elderly
TCMP	Tax Compliance Measurement Program
TDA	Taxpayer Delinquent Account
TDI	Taxpayer Delinquent Investigation
TDQAS	Training Development Quality Assurance System
TE/GE	Tax Exempt & Government Entities Operating Division
TFRP	Trust Fund Recovery Penalty
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number
TOP	Treasury Offset Program
TPI	Total Positive Income
TPNCs	Taxpayer Notice Codes
TRIS	Telephone Routing Interactive System
TY	Tax Year
VITA	Volunteer Income Tax Assistance
W & I	Wage and Investment Operating Division
WFTRA	Working Families Tax Relief Act

TAXPAYER ADVOCATE SERVICE

DIRECTORY

NATIONAL TAXPAYER ADVOCATE
1111 Constitution Avenue, NW
Room 3031, TA
Washington, DC 20224
Phone: 202-622-4300
FAX: 202-622-6113

DEPUTY NATIONAL TAXPAYER ADVOCATE
1111 Constitution Avenue, NW
Room 3031, TA
Washington, DC 20224
Phone: 202-622-4300
FAX: 202-622-6113

EXECUTIVE DIRECTOR, SYSTEMIC ADVOCACY
1111 Constitution Avenue, NW
Room 3219, TA:EDSA
Washington, DC 20224
Phone: 202-622-7175
FAX: 202-622-3125

CONGRESSIONAL AFFAIRS LIAISONS
1111 Constitution Avenue, NW
Room 3031, TA
Washington, DC 20224
Phone: 202-622-4321 or 202-622-4315
FAX: 202-622-6113

AREA OFFICES

NEW YORK/NEW ENGLAND
290 Broadway - 14th floor
New York, NY 10007
Phone: 212-298-2015
FAX: 212-298-2016

RICHMOND
400 N. 8th St. Room 328
Richmond, VA 23240
Phone: 804-916-3510
FAX: 804-916-3641

ATLANTA/INTERNATIONAL
401 W. Peachtree St.
Stop 101-R, Room 1970
Atlanta, GA 30308
Phone: 404-338-8710
FAX: 404 338-8709

MILWAUKEE
310 W. Wisconsin Ave.
Suite 1210 East Tower
Stop 1009 MIL
Milwaukee, WI 53203
Phone: 414-297-1646
FAX: 414-297-3485

DALLAS
4050 Alpha Road
Mail Stop 1005, Room 1240A
Dallas, TX 75244-4203
Phone: 972-308-7019
FAX: 972-308-7166

OAKLAND
1301 Clay St., Suite 1030-N
Oakland, CA 94612
Phone: 510-637-2070
FAX: 510-637-3189

SEATTLE
915 2nd Ave., Stop W-404
Seattle, WA 98174
Phone: 206-220-4356
FAX: 206-220-4930

SMALL BUSINESS/ SELF EMPLOYED CAMPUSES
312 Elm Street, Suite 2250
Cincinnati, OH 45202
Phone: 859-669-5556
FAX: 869-669-5808

DIRECTOR, INDIVIDUAL ADVOCACY
1111 Constitution Avenue, NW
Room 3219, TA:DIA
Washington, DC 20224
Phone: 202-622-4711
FAX: 202-622-3125

DIRECTOR, BUSINESS ADVOCACY
1111 Constitution Avenue, NW
Room 3219, TA:DBA
Washington, DC 20224
Phone: 202-622-1412
FAX: 202-622-3125

CAMPUS OFFICES

ANDOVER
310 Lowell St., Stop 120
Andover, MA 01812
Phone: 978-474-5549
FAX: 978-247-9034

ATLANTA
4800 Buford Hwy, Stop 29-A
Chamblee, GA 30341
Phone: 770-936-4500
FAX: 770-234-4443

AUSTIN
3651 S. Interregional Hwy.
Stop 1005 AUSC
Austin, TX 78741
Phone: 512-460-8300
FAX: 512-460-8267

BROOKHAVEN
1040 Waverly Avenue, Stop 02
Holtsville, NY 11742
Phone: 631-654-6686
FAX: 631-447-4879

CINCINNATI
201 Rivercenter Blvd., Stop 11-G
Covington, KY 41011
Phone: 859-669-5316
FAX: 859-669-5405

FRESNO
5045 East Butler Ave.
Stop 1394
Fresno, CA 93888
Phone: 559-442-6400
FAX: 559-442-6507

KANSAS CITY
2306 East Bannister Rd.
Stop 1005 ROE
Kansas City, MO 64131
Phone: 816-926-2493
FAX: 913-696-6390

MEMPHIS
5333 Getwell Road, Stop 13-M
Memphis, TN 38118
Phone: 901-395-1900
FAX: 901-395-1925

OGDEN
1973 N. Rulon White Blvd.
Stop 1005
Ogden, UT 84404
Phone: 801-620-7168
FAX: 801-620-3096

PHILADELPHIA
11601 Roosevelt Blvd.
Stop SW-820
Philadelphia, PA 19154
Phone: 215-516-2499
FAX: 215-516-2677

LOCAL OFFICES BY STATE AND LOCATION

ALABAMA
801 Tom Martin Drive
Room 151-PR
Birmingham, AL 35211
Phone: 205-912-5631
FAX: 205-912-5156

ALASKA
949 E 36th Ave., Stop A-405
Anchorage, AK 99508
Phone: 907-271-6877
FAX: 907-271-6157

ARIZONA
210 E. Earll Dr., Stop 1005 PHX
Phoenix, AZ 85012-2623
Phone: 602-207-8240
FAX: 602-207-8250

ARKANSAS
700 West Capitol Street,
Stop 1005 LIT
Little Rock, AR 72201
Phone: 501-324-6269
FAX: 501-324-5183

CALIFORNIA (LAGUNA NIGUEL)
24000 Avila Road, Stop 2000
Laguna Niguel, CA 92677
Phone: 949-389-4804
FAX: 949-389-5038

CALIFORNIA (LOS ANGELES)
300 N. Los Angeles St.
Stop 6710 LA
Los Angeles, CA 90012
Phone: 213-576-3140
FAX: 213-576-3141

CALIFORNIA (OAKLAND)
1301 Clay St., Suite 1540-S
Oakland, CA 94612
Phone: 510-637-2703
FAX: 510-637-2715

CALIFORNIA (SACRAMENTO)
4330 Watt Ave., Stop SA5043
Sacramento, CA 95821
Phone: 916-974-5007
FAX: 916-974-5902

CALIFORNIA (SAN JOSE)
55 S. Market St., Stop 0004
San Jose, CA 95113
Phone: 408-817-6850
FAX: 408-817-6851

COLORADO
600 17th St., Stop 1005 DEN
Denver, CO 80202-2490
Phone: 303-446-1012
FAX: 303-446-1011

CONNECTICUT
135 High Street, Stop 219
Hartford, CT 06103
Phone: 860-756-4555
FAX: 860-756-4559

DELAWARE
409 Silverside Road
Wilmington, DE 19809
Phone: 302-792-6679
FAX: 302-792-6648

DISTRICT OF COLUMBIA (MARYLAND)
31 Hopkins Plaza, Room 940
Baltimore, MD 21201
Phone: 410-962-2082
FAX: 410-962-9340

FLORIDA (FT. LAUDERDALE)
7850 SW 6th Court, Room 265
Plantation, FL 33324
Phone: 954-423-7677
FAX: 954-423-7680

FLORIDA (JACKSONVILLE)
841 Prudential Drive, Suite 100
Jacksonville, FL 32207
Phone: 904-665-1000
FAX: 904-665-1817

LOCAL OFFICES BY STATE AND LOCATION *(cont.)*

GEORGIA
401 W. Peachtree St., NW
Summit Bldg., Room 510
Stop 202-D
Atlanta, GA 30308
Phone: 404-338-8099
FAX: 404-338-8096

HAWAII
300 Ala Moana Blvd., #50089
Stop H-405/Room 1-214
Honolulu, HI 96850
Phone: 808-539–2870
FAX: 808-539-2859

IDAHO
550 W. Fort St., Box 041
Boise, ID 83724
Phone: 208-387-2827
FAX: 208-387-2824

ILLINOIS (CHICAGO)
230 S. Dearborn St.
Room 2860, Stop-1005 CHI
Chicago, IL 60604
Phone: 312-566-3800
FAX: 312-566-3803

ILLINOIS (SPRINGFIELD)
3101 Constitution Drive
Stop 1005 SPD
Springfield, IL 62704
Phone: 217-862-6382
FAX: 217-862-6373

INDIANA
575 N. Pennsylvania St.
Room 581 - Stop TA770
Indianapolis, IN 46204
Phone: 317-226-6332
FAX: 317-226-6222

IOWA
210 Walnut St.
Stop 1005 DSM, Room 483
Des Moines, IA 50309
Phone: 515-284-4780
FAX: 515-284-6645

KANSAS
271 West 3rd St. North
Stop 1005-WIC, Suite 2000
Wichita, KS 67202
Phone: 316-352-7506
FAX: 316-352-7212

KENTUCKY
600 Dr. Martin Luther King Jr.
Place, Room 325
Louisville, KY 40202
Phone: 502-582-6030
FAX: 502-582-6463

LOUISIANA
1555 Poydras Street
Suite 220, Stop 2
New Orleans, LA 70112
Phone: 504-558-3001
FAX: 504-558-3348

MAINE
68 Sewall Street, Room 313
Augusta, ME 04330
Phone: 207-622-8528
FAX: 207-622-8458

MARYLAND
31 Hopkins Plaza, Room 940
Baltimore, MD 21201
Phone: 410-962-2082
FAX: 410-962-9340

MASSACHUSETTS
JFK Building
25 New Sudbury St., Room 725
Boston, MA 02203
Phone: 617-316-2690
FAX: 617-316-2700

MICHIGAN
McNamara Federal Bldg.
477 Michigan Ave.
Room 1745 - Stop 7
Detroit, MI 48226
Phone: 313-628-3670
FAX: 313-628-3669

MINNESOTA
316 North Robert St.
Stop 1005 STP, Room 383
St Paul, MN 55101
Phone: 651-312-7999
FAX: 651-312-7872

MISSISSIPPI
100 West Capitol Street
Stop JK31
Jackson, MS 39269
Phone: 601-292-4800
FAX: 601-292-4821

MISSOURI
1222 Spruce St.
Stop 1005 STL, Room 10.314
St Louis, MO 63103
Phone: 314-612-4610
FAX: 314-612-4628

MONTANA
10 West 15th St., Suite 2319
Helena, MT 59626
Phone: 406-441-1022
FAX: 406-441-1045

NEBRASKA
1313 Farnam St.
Stop 1005 OMA, Room 208
Omaha, NE 68102
Phone: 402-221-4181
FAX: 402-221-3051

NEVADA
4750 W. Oakey Blvd.
Stop 1005 LVG
Las Vegas, NV 89102
Phone: 702-455-1241
FAX: 702-455-1216

NEW HAMPSHIRE
Thomas J. McIntyre Federal Bldg.
80 Daniel Street, Room 403
Portsmouth, NH 03801
Phone: 603-433-0571
FAX: 603-430-7809

NEW JERSEY
955 South Springfield Avenue
1st Floor
Springfield, NJ 07081
Phone: 973-921-4043
FAX: 973-921-4355

NEW MEXICO
5338 Montgomery Blvd., NE
Stop 1005 ALB
Albuquerque, NM 87109
Phone: 505-837-5505
FAX: 505-837-5519

NEW YORK (ALBANY)
Leo O'Brien Federal Building
1 Clinton Square, Room 354
Albany, NY 12207
Phone: 518-427-5413
FAX: 518-427-5494

NEW YORK (BROOKLYN)
10 Metro Tech Center
625 Fulton Street
Brooklyn, NY 11201
Phone: 718-488-2080
FAX: 718-488-3100

LOCAL OFFICES BY STATE AND LOCATION *(cont.)*

NEW YORK (BUFFALO)
201 Como Park Blvd.
Buffalo, NY 14227-1416
Phone: 716-686-4850
FAX: 716-686-4851

NEW YORK (MANHATTAN)
290 Broadway - 7th Floor
Manhattan, NY 10007
Phone: 212-436-1011
FAX: 212-436-1900

NORTH CAROLINA
320 Federal Place, Room 125
Greensboro, NC 27401
Phone: 336-378-2180
FAX: 336-378-2495

NORTH DAKOTA
657 Second Ave., North
Stop 1005 FAR, Room 244
Fargo, ND 58102
Phone: 701-239-5141
FAX: 701-239-5323

OHIO (CINCINNATI)
550 Main St., Room 3530
Cincinnati, OH 45202
Phone: 513-263-3260
FAX: 513-263-3257

OHIO (CLEVELAND)
1240 E. 9th St., Room 423
Cleveland, OH 44199
Phone: 216-522-7134
FAX: 216-522-2947

OKLAHOMA
55 North Robinson
Stop 1005 OKC, Room 138
Oklahoma City, OK 73102
Phone: 405-297-4055
FAX: 405-297-4056

OREGON
1220 S.W. 3rd Ave., Stop O-405
Portland, OR 97204
Phone: 503-326-2333
FAX: 503-326-5453

PENNSYLVANIA (PHILADELPHIA)
600 Arch Street, Room 7426
Philadelphia, PA 19106
Phone: 215-861-1304
FAX: 215-861-1613

PENNSYLVANIA (PITTSBURGH)
1000 Liberty Avenue, Room 1602
Pittsburgh, PA 15222
Phone: 412-395-5987
FAX: 412-395-4769

RHODE ISLAND
380 Westminster Street
Providence, RI 02903
Phone: 401-525-4200
FAX: 401-525-4247

SOUTH CAROLINA
1835 Assembly Street
Room 466, MDP-03
Columbia, SC 29201
Phone: 803-253-3029
FAX: 803-253-3910

SOUTH DAKOTA
115 4th Ave., Southeast
Stop 1005 ABE, Room 114
Aberdeen, SD 57401
Phone: 605-226-7248
FAX: 605-226-7246

TENNESSEE
801 Broadway, Stop 22
Nashville, TN 37202
Phone: 615-250-5000
FAX: 615-250-5001

TEXAS (AUSTIN)
300 E. 8th St.
Stop 1005-AUS, Room 136
Austin, TX 78701
Phone: 512-499-5875
FAX: 512-499-5687

TEXAS (DALLAS)
1114 Commerce St.
MC 1005DAL, Room 1004
Dallas, TX 75242
Phone: 214-413-6500
FAX: 214-413-6594

TEXAS (HOUSTON)
1919 Smith St.
Stop 1005 HOU, Room 1650
Houston, TX 77002
Phone: 713-209-3660
FAX: 713-209-3708

UTAH
50 South 200 East
Stop 1005 SLC
Salt Lake City, UT 84111
Phone: 801-799-6958
FAX: 801-799-6957

VERMONT
Courthouse Plaza
199 Main Street
Burlington, VT 05401-8309
Phone: 802-860-2089
FAX: 802-860-2006

VIRGINIA
400 N. 8th St., Room 916
Richmond, VA 23240
Phone: 804-916-3501
FAX: 804-916-3535

WASHINGTON
915 2nd Ave., Stop W-405
Seattle, WA 98174
Phone: 206-220-6037
FAX: 206-220-6047

WEST VIRGINIA
425 Julianna St., Room 3012
Parkersburg, WV 26101
Phone: 304-420-6616
FAX: 304-420-6682

WISCONSIN
310 W. Wisconsin Ave.
Suite 1298 West Tower
Stop 1005 MIL
Milwaukee, WI 53203
Phone: 414-297-3046
FAX: 414-297-3362

WYOMING
5353 Yellowstone Road
Cheyenne, WY 82009
Phone: 307-633-0800
FAX: 307-633-0918

INTERNATIONAL-PUERTO RICO
San Particio Office Bldg
7 Tabonuco Street, Room 200
Guaynabo, PR 00966
Phone: 787-622-8930 (Spanish)
787-622-8940 (English)
FAX: 787-622-8933